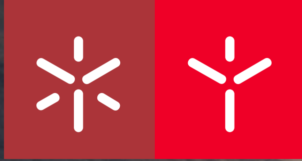

University of Minho
School of Law

SELECTED ESSAYS ON INTERNATIONAL BUSINESS LAW

EDITOR **JOÃO SÉRGIO RIBEIRO**

JusGov
RESEARCH CENTRE FOR JUSTICE AND GOVERNANCE

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RESEARCH CENTRE FOR JUSTICE AND GOVERNANCE

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Editor: João Sérgio Ribeiro

English Language Editing by Changyue Yin | Cindy Luo | Isabella Fierro

Authors: Ana Luísa Gonçalves Novais | Ana Oliveira
Anabela Susana de Sousa Gonçalves | Elif Nazli Birgi | Francisco Andrade de Portugal
Isabel Fidalgo da Silva | João Novo Faria Lages | João Sérgio Ribeiro
José Pedro Correia Fernandes | Maria João Maurício | Tilmar W. Goos | Yi Zheng

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Foreword

Within the framework of the LL.M. in European and Transglobal Business Law, graduate students, during their theses preparations, have been doing research in very differentiated and groundbreaking areas of law with excellent results. Although the dissertations produced are very fine pieces of research and are worthy of disseminating, they are too lengthy to be published in an edited book such as this one. As a result, in my capacity as the Director of the LL.M., I requested some of our graduates to write an essay summarising their Masters theses. Although all of our graduates have extremely busy schedules and are currently professionals of high responsibility, they reacted with positivity and enthusiasm, delivering the requested essays in record time.

This book is, therefore, mostly the result of our graduate students' commitment to research and the pursuit of excellence.

The last of part the book includes essays produced by academics with a strong link to the programme. The idea of including a small number of essays related to the content of the LL.M. programme, written by academics, is a development that was not initially planned. There was neither a call for academic contributions nor for any formal proceeding. The inclusion of those extra essays is merely the result of a voluntary and spontaneous desire for accompanying the graduates' efforts within the extremely tight schedule to publish the book. As we benefit from this experience in the future, we will bring together essays by the programme's faculty and will also include some essays by students who, if future circumstances allow, may want to be associated with the initiative, fostering once again close ties between students and Professors, which mirror the spirit of the LL.M. in European and Transglobal Business Law.

I am very grateful to my fellow authors: Ana Luísa Gonçalves Novais, Ana Oliveira, Anabela Susana de Sousa Gonçalves, Elif Nazli Birgi, Francisco Andrade de Portugal, Isabel Fidalgo da Silva, João Novo Faria Lages, José Pedro Correia Fernandes, Maria João Maurício, Tilmar W. Goos, and Yi Zheng.

In addition to the listed authors, this book could not have been produced without the conscientious efforts of Changyue Yin, Cindy Luo and Isabella Fierro, who edited the English language of the chapters it comprises.

Finally, I would like to express a word of gratitude to JUSGOV for being able to create a research atmosphere for projects like this to thrive and for providing an invaluable financial support to this important publication.

JOÃO SÉRGIO RIBEIRO

Academic coordinator of the conference and of this publication
Vice-Dean of the School of Law of University of Minho
Tax Law Professor
Director of the LL.M. degree in European and Transglobal Business Law

PART I

SELECTED ESSAYS

Standard Terms and Contractual Justice

Ana Luísa Gonçalves Novais *

1. Introduction

Since the first moment I became aware of Standard Form Contracts or Contracts of Adhesion, a question always arise: How can such unfairness not be fought?

The most popular type of contract in our time is that of adhesion, especially in consumer transactions. They are pre-printed forms containing non-negotiated provisions that are offered to the consumer on a take-it-or-leave-it basis. The terms are normally presented in fine print and are drafted by and on behalf of one of the parties to the contract, normally the one with superior bargaining power, that is, business organizations.

With the expansion of the worldwide market, the transactions had to become standardized, or else it would have been impossible to keep the market running. The contracts are standardized for many reasons: first, they are used to supply mass demands for goods and services; second, they are drafted for an infinite number of persons; third, they promote the efficiency of the trade, reducing transaction costs; and fourth, they strengthen the power of the organizations that enjoy their use.

Although these contacts are helpful to some extent, they can also be deceiving because consumers are expected to accept or decline and are therefore unable to negotiate. He either accepts or not. If all consumer transactions are made through these contracts, the consumer cannot choose anything other than

* Due Diligence Officer at BNP Paribas. Master LL.M in European and Transglobal Business Law at University of Minho – Law School, dissertation concluded under the aegis of *Standard Terms and Contractual Justice* (2016). Executive Education in General Management at Católica Business School. For further comprehension of this article it is suggested to consult the above-mentioned master's dissertation.

an imposition. This imposition of terms on the consumer is, in fact, the power of "making" law by the organizations. If a contract is a form of law-making between two private parties then a party is effectively making law by imposing a contract onto the other party. Moreover, the organizations impose various types of unfair clauses of which the consumer is not aware.

Powerful business enterprises distort the principles of contract law to achieve their own goals. For this reason, law regarding contracts of adhesion must/should be separated from the "ordinary" contract law. The contractual relationship is no longer equal, because one of the parties has much more power than the other. Also, I believe that if organizations are capable of "making" law, they must be subject to any kind of "democratic control". The consumer is not yet sufficiently protected against the abuses of this practice.

The path to achieving contractual justice is one of determining the appropriate sphere in which contracts of adhesion are contained. They are not contracts *stricto sensu*, so why are they still governed by principles of contract law? More precisely why are they still governed by private law if they have all the characteristics of a "public" contract?

Contracts of adhesion must have the direct intervention of the State. Otherwise, organizations will keep imposing all kinds of unfair terms, with no fear of being discovered. These days, organizations do not even think about any legal consequences because the law regarding this problem is full of contradictions. Moreover, they prepare their "contracts" to be close to the threshold of legality, because they have the power and the means to do so. On the other hand, the consumer is facing the "world" alone. Most of the time, the consumer does not have the means for a reasonable defense against these organization.

Additionally, the consumer has been deceived in the first place because he/she did not have all the information in the beginning of the transaction, unlike these organizations.

This still happens in the twenty-first century. Incredible how can the law itself admit such injustice.

This study will analyse American jurisprudence and fundamental principles of Contract Law such as Freedom of Contract.

2. General Considerations about Standard Form Contracts

Standard form contracts are the type of contracts that are most used in the modern economy. This is due to the reality of mass production and the consumer economy in which we live. The birth of these contracts was inevitable to keep the market functioning. Mass production leads to mass consumption, and in order to facilitate it, businesses tend to use standard form contracts.

One might wonder about the standard form contract.

Most people have contracted in the standard form through actions such as opening a bank account, taking out insurance, buying a car, getting the house fixed or even taking a shirt to the laundry are examples of standard contracts. They are essentially consumer contracts that use standardized, non-negotiated terms, usually in pre-printed forms. These contracts may also be known as "boilerplate contracts", "contracts of adhesion" or "take-it-or-leave it" contracts. The terms, written in fine print, are drafted by or on behalf of one party to the transaction, normally the party that has more bargaining power. The terms are not even negotiated by the consumer. Standard form contracts also play an important role in the efficiency of mass distribution of goods and services. They reduce costs by eliminating the need of negotiating every detail and this reflects in reduction of prices, from which all society benefits.

Consumer adhesion standard form contracts and the proliferation of unfair supplier-biased terms are characteristic of the modern day consumer market[1]. Many countries have been enacting legislation that aims at providing a general framework to deal with the possibly unfair terms in these contracts. Examples include in Germany, the Standard Terms Act[2], in 1976, in Israel the

[1] It is estimated that about 98 per cent of all written contracts made in USA are made on standard forms: see SLAWSON, «Standard Form Contracts and Democratic Control of Law Making Power», in *Harv. L. R.*, 84, 1971, p. 529. That may not be the case in other countries. Yet, due to the highly internationalized marketing methods used in today's world, it's tempting to believe that Slawson comment is not too far from reality.

[2] See SANDROCK, «The Standard terms Act 1976 of West Germany», in *Amer. J. Comp. L.*, 26, 1978, p. 551; ALPA, «Protection of Consumers against Unfair Contract Terms: Legislative Patterns of Controlling Adhesion Contracts in Europe», in *Willamette L. R.*, 105, 1976, pp. 267, 274-276.

Standard Contract Law, in 1964[3], in Sweden, the Improper Contract Act, in 1977[4] and in the United Kingdom the Unfair Contract Terms Act, in 1977[5]. Most have been rectified by now due to either the implementation of the Unfair Contract Terms Directive by the EU, or to the sign of a need for adaptation to new circumstances of the market and law. By the same token, in the US the Section 211 of the *Restatement (Second) of Contracts*, entitled "Standardized Agreements" treats contracts of adhesion.

The conceptual base from which most of the legislation derives is the classical theory of contract as bargain resulting from agreement between parties to contracts of adhesion and the conclusion that unfair terms in these contracts result from breakdown in the classical contract bargaining process.

2.1. *Standard forms or adhesion contracts?*

The term "contract of adhesion" is widely used in the context of contemporary contracts[6], though the expression has not yet attained any accurate legal meaning. When referring to these contracts, there is the possibility of mistaking

[3] See DIAMOND, «The Israeli Standard Contracts Law, 5729-1969», in *I.C.L.Q.*, 14, 1965, p. 1410; GOTTSCHALK, «The Israeli Law on Standard Contracts», in *L.Q.R.*, 81, 1964, p. 32; HECHT, «The Israeli Law on Standard Contracts», in *Is. L.R.*, 3, 1968, p. 586; COMMENT, «Administrative Regulation of Adhesion Contracts in Israel», in *Colum. L.Rev.*, 66, 1966, p. 1341; LANDO, «Standard Contract: A Proposal and a Perspective», in *Scan. Stud. L.*, 10, 1966, p. 129; JACOBSEN, «The Standard Contracts Law of Israel», in *J.B.L.*, 1968, p. 325; BERG, «The Israeli Standard Contract Law 1964: Judicial Control of Standard Form Contracts», in *I.C. L.Q.*, 28, 1979, p. 560.

[4] See «Consumer Protection and Standard Contracts: The Swedish Experiment in Administrative Control», in *Amer. J. Comp. L.*, 22, 1974, p. 17; BERNITZ, «Consumer Protection and Standard Contracts», in *Scan. Stud. L.*, 17, 1973, p. 11; *Id.*, «Consumer Protection: Aims, Methods and Trends in Swedish Consumer Law», in *Scand. Stud. L.*, 20, 1976, p. 11; KING, *Consumer Protection Experiments in Sweden*, New Jersey, 1974.

[5] See TREITEL, *The Law of Contract*, London, 1979, pp. 179-193; CHESHIRE & FIFOOT, *Law of Contract*, London, 1981, pp. 159-173; COOTE, «Unfair Contract Terms Act», in *M.L.R.*, 41, 1978, p. 312; SEALEY, «Unfair Contract Terms Act 1977», in *C.J.L.*, 37, 1978, p. 15; ADAMS, «An Unfair Look at the Contract Provisions of the Unfair Contract Terms Act, 1977», in *M.L.R.*, 41, 1978, p. 703.

[6] See, *e.g.*, KESSLER, «Contracts of Adhesion: Some Thoughts about Freedom of Contract», in *Colum. L.R.*, 43, 1943, p. 629; BOLGAR, «The contract of Adhesion: A Comparison of Theory and Practice», in *Amer. J. Comp. L.*, 20, 1972, p. 53; LENHOFF, «Contracts of Adhesion and Freedom of Contract», in *Tul. L.R.*, 36, 1961-1962, p. 481; SCHUMAN, «Consumer Credit by Adhesion Contracts», in *Temp. L.Q.* 125, 1962, p. 281.

its significance. For example, the term is sometimes used to mean all standard form contracts. It may also refer to a broad range of contracts where the bargain is absent and, at other times, to refer only to consumer type contracts.

Due to their unclear meaning, contracts of adhesion must be examined closely at, more specifically, their core characteristics.

Henry Maine was one of the first to note the impact that standard form contracts would have in the future. In 1861, he observed that "the movement of the progressive societies has hitherto been a movement from Status to Contract"[7].

What Maine meant was that the society was moving away from the stratification based on fixed classes, as with feudalism, and was moving into the much revered "Freedom of Contract Era", where the people were free to transact with, and become obligated to, whomever they wished.

Nonetheless, just about a century ago, Nathan Isaacs speculated about whether the standard form contract phenomenon would be opposite to that transformation. That is, Isaacs became aware of the possibility that the rising of this type of contract could lead to the re-classification of the contracting masses into two categories: the dominating lords (the corporations using such contracts) and the subservient vassals (the consumers subject to such contracts). Hence, his observation was not totally incorrect as the rise of this standard form contracts revealed the growing disparity in bargaining power between industry and consumers[8].

The first time that the contract of adhesion was referred to as a transaction type was in 1901, by the French jurist Raymond Saleilles, who identified what he called "*contracts d'adhésion*"[9]. Saleilles stated that these contracts consist of pre-formulated stipulations in which the will of one party dominates the transaction. This dominance lies in relation to not only a single individual, but also to an entire group of individuals who may at any time wish to participate

[7] HENRY SUMNER MAINE, *Ancient Law*, 170, 1861 (Transactions Publishers 2002).

[8] See ISAACS, «The Standardizing of contracts», in *Yale L. J.*, 27, 1917, p. 34.

[9] SALEILLES, *De la Déclaration de Volonté*, 1901.

in such a transaction[10]. Some illustrations of this type of contract are collective labour contracts in large industries and railway transportation contracts[11]. Saleilles asserted that these contracts are similar to legislative enactments and should be interpreted "in the interests of the collectivity to which they are addressed (...) in the sense called for by both good faith and economic relations involved"[12].

The topic that Saleilles discussed most in differentiating contracts of adhesion from other contracts was the need to adopt a different method of interpretation. According to him, contracts of adhesion differed from ordinary contracts in that the juridical basis of the latter type was not consensus (or consent), but was adhesion to one party's stipulations. For this reason, Saleilles suggested a diverse interpretation technique.

Then, in 1919, the expression contracts of adhesion entered the Anglo-American vocabulary at the hands of Professor Patterson, who embraced the Saleilles thesis. In an article on life insurance contracts, Patterson said that the "contract is drawn up by the insurer and the insured, who merely adheres to it, has little choice as to its term"[13]. Patterson, like Saleilles, used this analysis to show why contracts of adhesion should be interpreted differently from ordinary contracts, when classifying a contract as an "adhesion contract", it should be interpreted through a particular method.

Another important contribution in this discussion was made by Friedrich Kessler[14], who still has one of the leading articles regarding the contract of adhesion[15]. In it, he broadened the idea of the adhesion contract. For Kessler, the arrival of this type of contract was inspired by the need to encourage business

[10] See PATTERSON, «The Interpretation and Construction of Contracts», in *Colum. L.R.*, 1964, pp. 833-856, and AMOS & WALTON, *Introduction to French* Law, London, 1966, p. 152.

[11] SALEILLES, *De la Déclaration de Volonté*, *cit.*, p. 230.

[12] *Ibid.*

[13] See PATTERSON, «The Delivery of a Life Insurance Policy», in *Harv. L. R.*, 33, 1919, p. 198.

[14] KESSLER, «Contracts of Adhesion: Some Thoughts about Freedom of Contract», *cit.*

[15] Leff refers to this article as "the most elegant and powerful discussion of the adhesion contract". See LEFF, «Contracts as Thing», in *Amer. U. L. R.*, 19, 1970, pp. 131, 142.

activity and mass production[16]. Because these are so different from ordinary contracts, totally new legal principles are necessary to regulate these contracts. Kessler wrote: "It is not even profitable to spend the energy of the counsel, the money of clients and the time and analysis of the judges in discussing the problems presented by contracts of adhesion in terms established legal principles and to proclaim that recovery is contrary to the well settled principles of contract law".

It is perceivable that Kessler called for not only a different mode of interpretation, but for a new set of legal principles.

Kessler was quite persistent in referring to the adhesion contract as a distinct, legitimate transaction type, which is capable of generating separate legal principles. This intrigued modern commentators, who started to collect the various distinguishing features of adhesion contracts from ordinary contracts.

One of these commentators was Arthur Lenhoff[17], who observed some features of the contracts of adhesion and then enumerated their five main characteristics:

1. The contracts are based on standard forms.

2. They are used to supply mass demands for goods and services.

3. They are drafted for an infinite number of persons, i.e. for the public, rather than a single individual.

4. Their use is entangled with the superior bargaining power of the stipulator which is, to a certain extent, a monopolistic body.

5. The individual customer has no bargaining power; he/she must either adhere to the contract or refuse the contract all together[18].

---

[16] "The effect of mass production and mass merchandising is to make all consumer forms standard, and the combined effect of economics and the present law is to make all standard forms unfair. Mass production and mass merchandising work to make all forms standard because non-standard form is characteristically just as expensive for a seller to make and sell as is a nonstandard tangible product". See SLAWSON, «Standard Form Contracts and Democratic Control of Law Making Power», *cit.*, p. 529.

[17] See LENHOFF, «Contracts of Adhesion and Freedom of Contract», *cit.*

[18] *Ibid.*, pp. 481-482.

This description, however, does not perfectly fit all of this type of contract. Because of this, it is imperative to clarify some notions. Lenhoff states that adhesion contracts are based on standard forms, but all of the contracts based on standard forms may not mean exactly the same as some commentators tend to incorrectly state. There are some differences between the adhesion contract and another type of standard form contract, namely the commercial standard form contract[19].

The commercial standard form contract takes place between parties who are engaged in trade, business or commerce and who have relatively equal bargaining power. There is a case that addresses this issue and which states that: "The clauses of these (contracts) have been settled over the years by negotiations by representatives of the commercial interests involved and have been widely adopted because experience has shown that they facilitate the conduct of the trade (...)"[20]. An example of this sort of contract is a standard form building contract.

The adhesion type standard form contract, in contrast, is concluded between parties of relatively unequal bargaining power, on a standard form produced by, or on behalf of, the party with the stronger bargaining position. In the case referred above, Lord Diplock creates a description of these type of contracts, where he held the following: "The terms of this kind of standard form have not been the subject of negotiation representing the interests of the weaker party. They have been dictated by that party whose bargaining power, either exercised alone or in conjunction with others providing similar goods or services, enables him to say: 'If you want these goods or services at all, they are the only terms on which they are obtainable. Take it or leave it'"[21].

This unequal bargaining is possibly due to the existence of relative market power by one party to an adhesion contract. Lenhoff was of the opinion that the use of adhesion contracts implicates monopoly power. In fact, he furthers this issue when in suggesting that the adhesion contracts indicate the absence of competitive markets. It is quite possible for firms in a given industry, finding it

[19] See SALES, «Standard Form Contracts», in *M.L.R.*, 16, 1953, p. 318.

[20] *Schroeder Music Co. Ltd v. Macaulay* [1974] 3 *All E. R. 616, 624*, per Lord Diplock.

[21] *Schroeder Music Co. Ltd v. Macaulay* [1974] 3 *All E. R. 618, 624*, per Lord Diplock.

economical to use standard form contracts, to refuse to negotiate with purchasers, but nevertheless to have competitive terms in standard forms[22]. Hence, adhesion contracts may be found in workably competitive markets, and they do not need to be any monopoly as such to create and maintain an adhesion situation. Though, such a situation can be created where contracts are offered on nearly identical terms by competitors who dominate the market[23]. When Lenhoff referred to "monopoly power" it must be understood in this former sense.

Another aspect of Lenhoff's description of the adhesion contracting process deserves attention. He mentions that the weaker party must "adhere" to the contract, or no contract can result. This is not enough to emphasize one of the most distinguishing features of the contract of adhesion: that the contract involves a disqualification of the element of bargaining over terms. The contract procedure is much simpler than the classical contract. When using this contracting, the weaker party is presented with a form where it simply has to sign or not. Thus, the contracting process is actually a co-operative act by the weaker party done in agreement, rather than by way of making an agreement.

3. Kessler, Rakoff and Slawson's view on contracts of adhesion – Public or private approach?

Kessler, Rakoff and Slawson had divergent points, but all of them perceived that contracts of adhesion are a public affair. They believed that someday, an entire body of law would be born to remedy the failures experienced so far.

Kessler, for instance, recognized that the concepts of contract law are motionless, rather than static, as is the view of most people. People create religious separation between the public and private without recognizing the mixture of the two, which exists today.

Regarding contract law, we still adopt the private perspective as if the contract relationship has remained unchanged, when in fact the opposite happens.

[22] See POSNER, *Economic Analysis of Law*, Toronto, 1977.

[23] See, *e.g.*, *Henningsen v Bloomfield Motors Inc.*, 161A 2d. 69 (1961).

The contract is no longer between two equal individuals. Instead it is one individual versus an institution, what Kessler called a "contract of adhesion". However, people have the tendency to generalize. While contract law is largely seen as a private issue, the public law administration law is seen as purely public, because it is the state's duty to govern it. They do so because it is socially acceptable and practicable to place people that are "equal" on one side, and institutions, on the other.

However, everyone fails to recognize that private businesses are taking advantage of this widespread inertia. People cannot remain tied to the traditional legal concepts just out of the fear of change. Change will be difficult but pleasurable. If people separate individuals and institutions and if the market is perceived as an institution, then it should be governed by public law, or at least controlled by it. The problem is that everything related to contracts remains in the private sphere, as if contracts were still made on an equal footing. They are not. More than that, they are made in an unfair manner, so that firms obtain the maximum profit. Even more, they are made by informed people, namely lawyers, so that they will remain legally enforceable. Kessler was the only author that perceived the shift in the institutional power. The exchanges can no longer be held in reserve for individuals but instead are no mainly made through powerful economic organizations at State level. The contract is no longer a private issue, it is rather public and institutional. In this context, the *laissez-faire* doctrine is no longer applicable.

It does not make sense to discuss the freedom of contract, if it is purely a private right. In the context of contracts of adhesion, many problems involving the freedom of contract arise. This principle, that it is also a right, implies that people voluntarily accept their contractual obligations. In other words, they have consented to the contract. From this principle arises another principle called private autonomy, which, in this context, enables enterprises and businesses to draft their own contracts. Therefore, freedom of contract implies a double discourse. On one hand, it calls for "voluntary consent" of the parties, and on the other, it lets a powerful organization draft a contract that will be delivered to a person that only has to sign or agree to it to be bound to its terms.

If the contract is already made without any negotiation and simply delivered, then consent will never be voluntarily given.

Questions arise concerning how a signature or a simple act of acceptance can be perceived as consent, when consent implies negotiation.

Freedom of Contract, as Kessler realized, should be balanced with the social importance of the type of contract. In this context, this freedom cannot be treated as if it were in the context of an ordinary contract, as it is visible that it is not fairly distributed to all members of the society. For this reason, Kessler said that "freedom of contract enables enterprises to legislate in a substantially authoritarian manner without using the appearance of authoritarian forms"[24]. That, in other words, means making effective law, which is not subject to any "democratic control". We should recall what Slawson argued, that most of the law's production gains legitimacy through the parties' consent while most standard forms do not. In the cases where such legitimacy does not exist, these contracts should not be legal. To be supported, standard form contracts must pass through a judicial control and review as is typically done for other types of law-making "not directly validated by democratic process". In other words, contracts of adhesion or standard form contracts, because they are not supervised or controlled, must be subject to some kind of control to ensure the consumer's protection. Law is being made and applied to consumers without any sort of higher control. The contracts of adhesion fall neither within the private sphere nor within the public one. Their basis and foundations are private, but their law-making is public, because they are applied to many individuals.

Since they make law for individuals, in the same manner as the legislature, they must be subject to public law scrutiny. The use of standard forms by organizations results in a high degree of authority for people in general. If we let standard forms continue to use them, this authority will increase even more. The need for democratic control is urgent. In Rakoff's words, "if the legal system wants to enforce such clauses, it must control the abuses of the practice"[25]. Ac-

[24] KESSLER, «Contracts of Adhesion: Some Thoughts about Freedom of Contract», *cit.*, p. 640.

[25] See RAKOFF, «Contracts of Adhesion: An essay in Reconstruction», in *Harv. L. Rev.*, 96, 1983, 1174, p. 1262.

cording to Slawson, the best path to control a standardized contract is through standards applied within an administrative law of contracts framework. This framework would have two types of standards: the authoritative standards, according to the higher court of the jurisdiction; and non-authoritative standards, referring to "reasons, principles, or considerations possessing no legal authority within the jurisdiction but of greater generality than the law being reviewed and serving to demonstrate that it is in the Public interest".

Then, when confronted with unfair standard, contracts judges could "identify, select and apply the correct standards for reviewing form terms in the same manner they use such standards to create common law"[26]. Slawson believes in giving some partial law-making power to the drafter, in the sense that it is the adherent who delegates the power to fill the form terms to the drafting party. Being so, it is the duty of the private parties to decide where the public interest lies, because this power was legally delegated to them. However, this solution seems far too general, for law-making legitimacy is dependent on many factors. In Slawson's words, "there being no private consent to support a contract of adhesion, its legitimacy rests entirely on its compliance with the standards in the public interest"[27].

Another issue that Kessler mentions is the monopolistic situation that might be enjoyed by the author of the contract, which years later was discredited by Rakoff.

There seems to be no relation between the use of standard form contracts and businesses with monopoly power. Even small companies today use these contracts. These days, due to the development of the global economy, contracts of adhesion or standard form contracts are needed to keep the market going. They are needed to promote the market efficiency and, as some argue, to lower costs to the consumer. Also, contracts of adhesion foster the development of the organizational structure of an economic organization, as they organize the internal hierarchy and minimize the need to delegate authority. However, this is

[26] SLAWSON, «Standard Form Contracts and Democratic Control of Law Making Power», *cit.*, pp. 558-60.

[27] *Ibid.*, p. 566.

not a plausible reason for the level of imposition on consumers that the enforcement involves.

But then, other questions come to mind. Why is the enforcement of form terms *prima facie* valid?

Slawson accepts and upholds the idea that standard form contracts are presumably enforceable because law-making is, socially, better accepted if decentralized. In other words, the law-making power should be divided, and not totally concentrated in the hands of the state. Rakoff, on the other side, is of the opinion that form terms contained in contracts of adhesion should be presumptively unenforceable. Rakoff focuses his analysis on the separation between contracts of adhesion and other types of ordinary contracts, and it seems the best option. Also, he separates the form terms as visible (normally the price term) and invisible (all the others). The visible terms are normally bargained whereas the invisible are not. However, setting the boundaries between visible and invisible is not an easy task. Promoting the non-enforceability of form terms may lead to an increase in litigation, both for the judiciary and the parties, because there will be a continuous reference to the background law. Conversely, deciding on the basis of enforceability seems to be the best choice to save review into precedent, or resort to trade usage. Also, it seems easier to keep the rule of enforceability of a form rather than applying the rule of law.

On the whole, the three authors agree that contracts of adhesion lack democratic control.

They are used to achieve the highest outcome possible for the organizations, with no mercy for the consumers. They make law and force consumers to accept it because there is no other method of achieving certain goals through the market itself. Contracts of adhesion must be governed by public law to some extent due to the fact that they are made for the public yet currently governed by private principles. A hybrid between public and private law would be a good option considering that these contracts, before being contracts of adhesion, are indeed public contracts.

Why is private contracting the only accepted form of contracting?

It is neither fair nor viable. It is difficult to acknowledge that the fear of disturbing the social and economic "equilibrium" is bigger than the fear of losing social justice.

4. Final conclusions and Recommendations

4.1. *Freedom of Contract*

The Freedom of Contract is one of the most discussed issues regarding Contracts of Adhesion. As the name refers, it is the freedom of individuals or groups to form contracts with whoever they want. This freedom is one of the bases on which the law is founded. Thus, it is the liberty of people to make arrangements or agreements, according to their intents and wills.

This principle plays a huge role in the acceptance of contracts of adhesion for many reasons. First, the idea of contracts of adhesion is based on the existence of such liberty. Without it, it would not be possible for a business to contract in such an authoritarian manner.

Second, although the purpose is to give room to parties to adapt the law to their own interest, businesses act in their own favor by establishing harsh clauses to their customers (who are unable to find better options from close competitors).

Third, the Freedom of Contract lies in the absence of governmental interference (except when a substantial public policy justifies its intervention). In other words, Freedom of Contract separates the state and the market, the private and the public. As Kessler says, "the law of contract has to be of their own making"[28] to provide individuals fairer solutions in the attainment of their own interests.

However, Freedom of Contract is not as static a concept as previously thought. Over the years, Freedom of Contract has changed its meaning and it did so, because contract itself is not what used to be. Contract was perceived as the result of free bargaining between two individuals, who meet each other on a

[28] KESSLER, «Contracts of Adhesion: Some Thoughts about Freedom of Contract», *cit.*, p. 629.

relation of similar economic reality. This contracting manifested their consent because it was individually negotiated and properly dickered. Today, due to the economic reality that lies in the capitalistic essence of the society, contracts are no longer a "meeting of minds".

According to Rakoff, Freedom of Contract "means uncoerced choice (...) linked to the human being, its development, its individualization, its fulfilment, in doing so – none of these values is visible by enforcing the organization's form"[29]. Thus, seeing the organization as an individual is the first error. An organization is an institution with power, information, and means to achieve its goals. Of course, an organization should have power to contract, but due to its prime position in many fields, its freedom of contract must be "moderated". It is misleading to consider an individual, normally is an average person in need of the products or services offered by these organizations, on equal footing with the same. The organizations do not actively participate in the deal, but simply provide the product or service.

The perception of the Freedom of Contract is one of the barriers to progress. Not the Freedom of Contract itself, but the perception given to it. The Courts, judges and legal actors across the world do not accept that the Freedom of Contract must be redefined but instead rationalized. This principle no longer fits reality because there does not exist any contract equality. The contractual relationship is currently composed of two parts, in which one is the consumer and the other is an unreachable organization that imposes its terms on a take-it-or-leave-it basis.

The consumer has no Freedom of Contract other than choosing the best alternative to its purchase. On the other side, the organization has the Freedom of Contract to do whatever it wants, such as drafting unfair contracts that are upheld by governments. All of this is possible due to the privileged power of business organizations which is rooted in money, profit, risk and speculation. The Government cannot subsist without the organizations' support, because they are responsible, in many ways, for the progress of our society. This is a possible reason as to why organizations are at times benefited at the expense of the

[29] RAKOFF, «Contracts of Adhesion: An essay in Reconstruction», *cit.*, p. 1236.

rest of a community. Freedom of Contract is not equally applied to all the people, and in the same extent, actually what occurs is quite the contrary. The Freedom of Contract is currently a "one-sided privilege"[30] that only a few enjoy, namely organizations, corporations, etc.

In effect, Freedom of Contract, that so-well established principle of law, it is to blame for all inertness to evolution.

Is it preferable to maintain the "prestabilized harmony" of the society structure and the legal certainty rather than battle for social justice? It is because of that Freedom that we people are losing ours. The problem rests on the contractual parties being completely separated. Kessler claims that Freedom of Contract "enables enterprisers to legislate in a substantially authoritarian manner without using the appearance of authoritarian forms"[31].

In other words, is due to Freedom of Contract and Private Autonomy that the organizations are capable of making contracts that impose their terms, obligations and duties. Organizations are effectively making law and, on the contrary, people are no longer in a fair position because they cannot impose any terms. It is not fair to permit an unfair relationship right from the beginning.

Freedom of Contract no longer exists. Maybe some remnants in other contractual relationships do. But when Contracts of Adhesion are at stake, it simply vanished. Freedom of Contract requires that the contracting parties voluntarily assume the contractual obligations. In this context, they do it but not "voluntarily", they are almost forced to do so. There might be two options to solve this problem concerning Freedom of Contract:

One, the whole redefinition of the contractual relationship, or at least the separation of this new type of contracting from the other types of contracts.

That is, the creation of a whole new body of law regarding to Contracts of Adhesion or Standard Form Contracts, since the current concepts do not fit the reality anymore.

Two, withdraw some of this Freedom of Contract to organizations. Since shifting seems too difficult, maybe the solution is to limit the drafting of con-

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[30] KESSLER, «Contracts of Adhesion: Some Thoughts about Freedom of Contract», *cit.*, p. 640.

[31] *Ibid.*

tracts by companies. Regular inspections to this companies coupled with regulation on the matter could be a start. Besides that, harsh fines should be administered to non-compliant companies. The fines must be so severe than the companies themselves would be more frightened to pay them than of losing the revenue that would be available if they did not comply.

4.2. *The Institutional Power (The Market and the State)*

The institutional power is the power held by entities like governments (the state) and corporations (the market) to control people and direct their behaviour. Entities with institutional power, and their agents, have the official authority or ability to decide what "is best" for the whole society. Institutional power exists in situations where authority has been socially approved and accepted as legitimate. Corporations or companies have considerable power over our lives, as well as the State. Law-making is considered to be *sui* generis to the State. However, when parties consent to a contract, they too are creating law – the power is divided by the State and the citizens. In this context, when an individual is entering into a contract, typically a standard form contract, the consent of that individual is sufficient in creating law. However, such consent is empty. The consumer, most of the times, does not even read the whole contract, but rather accepts the "visible terms" as Rakoff stated, which may include the price and others terms. The remaining invisible terms are usually the most problematic. Thus, this law-making power is "given" to the Market by consumers through their "empty" consent.

But why is that? Is it because consumers want to do so? Or is it a consequence of their necessity for something that only the Market has access to, namely services or products? It is probably the latter. Actually, there are institutions other than the State and the Market that control the individuals within the context of private law. For example, the labour relationship in modern industry, "where such domination is as much an achievement of liberty as is the limitation of governmental control"[32].

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[32] RAKOFF, «Contracts of Adhesion: An essay in Reconstruction», *cit.*, p. 1237.

Therefore, the State has the power because it is perceived as a "coordinator" of the whole society, whereas the Market has the power because of (consumers') contracts.

If the parties of a contract are creating law by consenting to it, and if a contract is only made with consent, then the Market, as the party holding more power, is imposing law through contracts and the consumer is legitimizing it through consent and socially accepting the law. Unintentionally, the consumers are giving the Market power, but that is because they do not have another option. Otherwise, they will live apart from the others (not socially included).

How can someone currently live without the aid of the Market?

Given these points, the holders of power on our society are the State and the Market. This is only possible due to the consumers' consent on the contracts they enter. This strengthens the Market power, their organization and their structure to the limit where they can be also called an institution.

4.3. *The call for a multiple system of contract law*

It is more than obvious that the current system does not respond to the needs of contract law, more particularly the needs resulting from the use of standard form contracts. It is true that the contract law has grown substantially in the past decades, but even so, it is not adequately prepared. Plenty doctrines have risen in the hopes of solving this problem, but unfortunately none of them have properly addressed the issue. While there are some helpful doctrines, but yet incomplete, others are completely lacking a meaningful explanation. As Rakoff argued "standard contracts call for a different law, but the problem lies in the principles applicable to them"[33]. Also, Kessler called for a different set of legal principles. The time has come for us to part from the doctrinal moorings and to begin to see things in a more practical way. One thing is Contract as such. Another are contracts of adhesion. The basis of the situation may be the same (an exchange or a transaction), but the path made is different. One is civilized and respectful of all the elder principles of contract law, while the other takes

[33] *Ibid.*, p. 1175.

advantage of the same principles through use and abuse to achieve the better possible outcome. The judges and other legal actors have to recognize that they are different realities.

Ordinary contracts are still adequate to the principles while contracts of adhesion distort the same principles. For instance, for Freedom of Contract, this freedom is no longer perfectly shared by the two parties. Instead one party, normally businesses, has much more freedom because it imposes whatever terms it wants in its forms while the other party is deprived from freedom by "allowing" the imposition of these same terms.

For that, much more protection must be given to the consumers, while the businesses must be highly controlled. The contract as contract of adhesion must be fully separated from the ordinary contract. Its principles, proceedings and rules. The principles, as we know them, at least must be adapted. But the impasse lies in this "adaption". It is very difficult to redraft everything again. The most advisable thing to do is adapt. There are many ideas of adaption, one of them being the Slawson's idea of an "administrative law of contracts". For him, the solution was the creation of a "set of legal principles which reconcile the interests of the issuers in setting such terms as they wish on an agreement and of the consumer in having his reasonable expectations fulfilled". Thus, Administrative law view is an attempt to maintain the unilateral or "delegated" cases of agency law-making consistent with the legislative purpose, made in the public interest.

This public law approach is difficult to implement, but its outcomes would be fairer than the ones achieved through private law. The Contract must remain in the private sphere, but in a field or area of contract different from the "ordinary" contracts. In the same manner that a marriage is a contract, but with another name and detached from regular contracts, so must be contracts of adhesion. Rakoff is correct when he says that there is a need for reconstruction (or adaption). As he said, "the need for that reconstruction, based on an open recognition that contracts of adhesion represent a different social practice from "ordinary contracts", is the essential point". However, the State must intervene in the fairness control. For that, it is the judges and legislatures' duty to create this new legal structure. More than creating this legal structure, they must respect

the rights of the consumers as a matter of public interest. These are not "individual" contracts, for they apply to the public in general. For that, consumers must be treated as a collective group, rather than an individual making a single transaction on a regular day in his/her life. We, as consumers, are obliged to "contract" that way.

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Debt Bias in Corporate Taxation: Possible Consequences and Solutions

*Ana Oliveira**

Introduction

The development of international trade and the growth of new business strategies have turned the world into a massive global market. As a result of increasing globalization and competitiveness, companies are vigorously reconsidering their business models and operational structures by relocating capital and labour from one country to another[1]. Companies operating in an international environment are usually provided with greater opportunities to enter new and more appealing markets and to produce at lower costs.

However, companies also face high costs and difficulties when operating in different countries, and these are usually associated with economic and cultural reasons[2] as well as non-harmonized legal structures[3]. Tax systems represent a typical example of this.

Direct tax systems fall within the sovereign competence of the states and, as a result, different tax rates are applied[4]. Different tax rates and different tax treatment leads to tax competition, which gives taxpayers possibility of choosing jurisdictions that provide them with better tax opportunities. The main purpose of a business is to maximize profits and to reduce costs. Since taxes are

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* Trainee-Lawyer at Gama Lobo Xavier, Luis Teixeira e Melo e Associados – Sociedade de Advogados, SP, RL, Guimarães, Portugal.

[1] FINNERTY *ET AL.*, *Fundamentals of International Tax Planning*, IBFD, 2007, p. 252.

[2] For a more detailed overview see DUNNING, «The Eclectic (OLI) Paradigm of International Production: Past, Present and Future», in *International Journal of the Economics of Business*, Vol. 8, No. 2, 2001, pp. 173-190.

[3] WENDT, *A Common Tax Base for Multinational Enterprises in the European Union*, Gabler, Wiesbaden, 2009, pp. 12 *et seq.*

[4] Considering direct taxation, this autonomy, however, may be considerably restricted by secondary EU law in the form of directives and by international tax treaties.

a major cost that companies have to face, they will try to exploit tax differentials in order to achieve tax optimization.

The methods by which a company is financed are very important given that they will influence the taxation of corporate income. For example, while interest payments are deductible for corporate tax purposes, equity returns are not. The deductibility of interest is an important factor in giving preference to debt over equity. So long as there is a tax advantage to prefer one form of financing over the other, companies will feel motivated to use it.

The different treatment given to debt and equity can also lead to aggressive tax planning, by which the deductibility of interest payments decreases the tax base in a high-tax jurisdiction, preferably ending up in a low-tax one.

Aggressive tax planning is a subject of broad and current interest in the international policy agenda, given that many countries face high levels of debt and huge pressure to generate tax revenue. We have witnessed a sort of cat-and-mouse game between companies – trying to reduce their tax liability through exploiting loopholes in existing tax rules; and governments – subsequently concerned with the loss of tax revenues[5]. States try to tackle this problem by adopting measures aimed at combating specific behaviours that, because of the risks they involve, deserve special attention.

One of the specific measures adopted to tackle debt exploitation is the thin capitalization regime, which attempts to prevent, on the one hand, excessive debt and, on the other, the movement of income for states whose tax jurisdictions are more attractive. To preserve their own tax revenues, many countries have adopted thin capitalization rules which have attracted considerable attention due to their possible interference with European law and interaction with tax treaty provisions.

This article concludes by analyzing the effectiveness of thin capitalization rules and by considering two possible tax alternatives (the ACE and the CBIT systems), which were designed to achieve more neutrality between debt and equity.

[5] FUEST, SPENGEL, FINKE *ET AL.*, «Profit Shifting and "Aggressive" Tax Planning by Multinational Firms: Issues and Options for Reform», Discussion Paper No. 13-078, 2013.

1. Debt vs. Equity: Brief Notes

Group financing is a major concern for international tax law policy makers because the methods companies choose to finance their operations will have an impact on the taxation of corporate income[6]. To raise capital and expand or save the business, companies need to explore financial resources. External financing can, therefore, be achieved by virtue of new equity or new debt.

Equity financing comprises the sale of ownership shares in the company in exchange for advanced payment per share. With this financing method, shareholders expect to recover their money by taking part in the company's growth. The return on investment will, therefore, be in accordance with the performance of the company.

With debt financing, capital is made available through a loan from a bank or a lender or through the sale of bonds. The money has to be paid back at a fixed interest rate within a stipulated period of time. Independently from the performance of the company in the following years, the terms of the loan usually remain the same as the return on investment that the lender expects to receive.

Even though equity and debt share the same economic purpose – to provide finance to the business – most jurisdictions treat equity and debt differently, and thus, some properties are used to distinguish them. Debt holders have a legal right to receive a return that is previously established, regardless of the financial status of the debtor. In what concerns equity holders, they receive a return that is changeable since it is dependent on the company's performance. In the case of insolvency, debt holders have a prior claim to the company's assets while equity suppliers receive any residual claims only after debt has been paid[7]. Also, suppliers of equity usually have control rights over the company while debt holders do not.

[6] SOMMERHALDER, «Approaches to Thin Capitalization», in *European Taxation*, March 1996, p. 82.

[7] SCHÖN *ET AL.*, «Debt and Equity: What's the Difference? A Comparative View», in *Competition and Tax Law Research Paper 09-09*, Munich, Max Planck for Intellectual Property, 2009.

For tax purposes, the most significant difference is that interest payments are deductible for corporate income tax purposes while equity returns are not. While equity investment seeks to create a return for the investor in the form of a distribution of taxable profits, the return on a loan investment is, for the payer, an expense that has to be met before the profits can be determined[8]. Moreover, the return on equity is taxed twice – at the level of distributing company and then in the hands of a recipient of dividends; whereas the return on the loan is taxed only once.

A benefit is conferred to debt as, to a certain degree, interest payments protect earnings from taxes. The trade-off theory of leverage acknowledges that tax advantages come from interest payments, since interest paid on debt is deductible and dividends paid on equity are not.

Tax benefits, among other factors, influence financing decisions. However, opinions diverge regarding which factors are considered to have more importance and how they may influence a firm's value.

2. Aggressive Tax Planning and Financial Policies

Tax planning, as a means of reducing or deferring the tax burden, is a practice that has accompanied taxation over centuries, and is, therefore, intrinsic to the existence of tax regimes. Tax planning is commonly defined as the set of acts which, under the law, are intended to reduce or minimize the tax burden of the taxpayer.

While tax avoidance comprises the use of legal methods, tax evasion is a practice not only objectionable from an ethical point of view but also illegal and punishable under the terms defined by tax codes.

Taxpayers have, on the one hand, a fundamental duty to pay their taxes, thereby contributing to the economic and social sustainability of the society in which they operate and, on the other, the freedom to fiscally plan their activities and their income to delimit the amount of their tax obligations. Tax planning is, therefore, a right of taxpayers.

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[8] SOSHNIKOV, «Structure and Elements of National Thin Capitalization Rules», in *International Group Financing and Taxes*, Wien, Linde, 2012, p. 57.

However, the issue of tax planning begins to be truly discussed when the behaviour of taxpayers deviates from the tax planning possibilities that the law, itself, deliberately allows and when taxpayers take advantage of legal forms and the letter of the law to achieve results that they would not get if they acted in the normal use of rules.

Aggressive tax planning comprises the practice of lawful acts but whose results may not be accepted by the law because they are contrary to the principles underlying the tax system. In this case, the acts and practices of taxpayers are, per se, lawful but the tax authorities may consider these concrete acts illegitimate to the extent that they only seek to obtain the elimination or reduction of taxes.

To reduce its tax burden, a multinational corporation has various ways to structure its activities. This tax planning may involve conventional decisions to structure a company in a tax-efficient way, but, there are also less conventional practices that take advantage of the specific characteristics of multinational companies, such as profit-shifting strategies.

Although there are numerous ways to shift profits, one prominent technique comprises the use of internal loans by borrowing from affiliates situated in low-tax jurisdictions and lending to affiliates situated in high-tax ones. This will result in the reduction of profits through the deduction of interest payments in the high-tax jurisdiction. These profits will then be taxed as earnings in the low-tax jurisdiction.

In accordance with Action 4 of the OECD BEPS project, base erosion and profit shifting risks may appear in three possible situations: "(i) groups placing higher levels of third party debt in high tax jurisdictions; (ii) groups using intra-group loans to generate interest deductions in excess of the group's actual third party interest expense; and (iii) groups using third party or intra-group financing to fund the generation of tax exempt income".

Another easily seen technique is the use of hybrid financial instruments. This is mainly because hybrid instruments in most countries can only be treated as equity or debt, which means that the income is either treated as profit distribution (dividends) or as interest. This classification is relevant because it will determine if the issuer can treat the income as tax-deductible, and it will define,

in some cases, if the received payments from the respective instrument are exempt from tax.

Hybrid mismatch arrangements usually aim at achieving one of the following results: "(i) the multiple deduction of the same expense in different countries, (ii) the deduction of a payment in the country of the payer without a corresponding inclusion in the country of the payee and (iii) multiple tax credits for a single amount of foreign tax paid"[9].

In this way, hybrid mismatch arrangements may considerably reduce the overall tax for taxpayers and raise several tax policy issues, affecting, for example, tax revenue, competition, economic efficiency and transparency.

The tax-bias towards debt financing may pose some risks such as distortions in the capital structure of companies and profit-shifting via transfer of debt. To mitigate this debt bias problem and to preserve their tax bases, countries have been adopting anti-abuse measures. Thin capitalization rules appear as effective measures to combat financial structures that are excessively leveraged.

3. Thin Capitalization Rules

A company is considered to be "thinly capitalized" when it has a high proportion of debt compared to its equity capital.

Thin capitalization rules establish a limitation on the tax deductibility of interest expenses that are considered excessive.

The purpose of such rules is to prevent improper shifting of income to the jurisdiction of the creditor, and the deduction of interest expenses regarding borrowings that are granted in better conditions than those granted to non-related parties.

Thin capitalization rules were then designed to restrict fraudulent interest deductions on loans that bear no relation with multinationals' effective borrowing needs and that are not based on solid business reasons.

[9] OECD, Hybrid Mismatch Arrangements, Tax Policy and Compliance Issues (2012), p. 11.

There are several mechanisms that are used to implement thin capitalization rules, such as fixed-debt ratios; earnings stripping rules; safe haven rules combined with the possibility of taxpayers demonstrating that another debt-equity ratio is adequate in a specific case; and application of the arm's length principle to define the debt-equity ratio that is allowed[10].

Despite their form maybe varying from country to country, a general feature of thin capitalization rules is that the interest deduction is denied for loans from foreign affiliates if the debt-equity ratio is above the established threshold.

The context of these rules may differ from the perspective of: (i) the debt-to-equity ratio or the safe haven; (ii) the consequences of the application of the thin capitalization rules, that is, if the tax system only denies the deduction of excessive interest expenses or if it also re-characterizes the excess amount as dividends and tax it accordingly; (iii) and the type of loans that may be considered to define the application of the general interest limitation rule (some EU member states restrict the application of the rule to loans granted by shareholders or related parties, whereas others extend its application to all types of loans regardless of whether or not there is a relation between the debtor and the creditor[11].

According to Action 4 of the OECD BEPS[12] (Base Erosion and Profit Shifting), the best practice approach prescribes a fixed ratio rule which aims to limit interest deductions of an entity to a fixed percentage of its profit, which is measured through the use of earnings before taxes, interest, depreciation and

[10] WIJNEN, «Thin capitalization rules and Tax Treaty Law», in *International Group Financing and Taxes*, Wien, Linde, Vol. 74, pp. 83-118.

[11] BRAVO, «Thin Capitalization Rules and EU Law/Fundamental Freedoms», in *International Group Financing and Taxes*, Wien, Linde, Vol. 74, pp. 119-143.

[12] The main purpose of the BEPS project is to find coherent and consistent solutions to fill the gaps in international tax rules that allow companies to legally but artificially shift their profits to low or no taxation jurisdictions. These instruments are developed and agreed upon by the governments of participating countries and constitute soft law instruments. They seek to treat cases of double non-taxation and also to improve the mechanisms to deal with cases of double taxation. Once these instruments are agreed upon, all participating countries can, in accordance with their legal and constitutional systems, implement them.

In the sequence of the report «Addressing Base Erosion and Profit Shifting» in February 2013, countries of the OECD and the G20 adopted a 15-point Action Plan to tackle beps in September 2013.

amortization (EBITDA) and taking into account tax numbers[13]. The EBITDA approach aims to ensure that a portion of the entity's profit is subject to taxation in the country.

EBITDA is the recommended measure of earnings to be applied, but the best practice gives countries the possibility to adopt earnings-based rules before interest and taxes (EBIT) and, in exceptional cases, allows countries to employ a fixed ratio rule based on asset values instead of earnings.

The fixed ratio rule is assumed by the OECD as a direct and relatively simple to apply rule aimed at ensuring that the interest deduction by an entity directly corresponds to its economic activity. This rule also relates these deductions with the taxable income of the entity, making it an efficient tool against tax planning.

An efficient fixed ratio rule requires countries to establish the benchmark fixed ratio rule to a level that is adequate to combat base erosion and profit shifting but also takes into account the differences between countries in terms of their legal framework and economic environment. According to the OECD, it is recommended that countries establish their benchmark fixed ratio rule within a corridor of 10% to 30%, considering certain factors proposed in Action 4.

Action 4 recognizes that the fixed ratio rule may be a blind instrument in the sense that it does not consider that groups operating in different sectors may require different levels of leverage, and even within the same sector, certain groups may be more leveraged due to non-tax reasons. If the benchmark fixed ratio rule is established at a level effective enough to combat base erosion and profit shifting, it can cause double taxation for groups that are leveraged above this level[14].

In this way, the best practice approach gives countries the possibility to combine a fixed ratio rule with a group ratio rule that, in certain cases, allows an entity to deduct more interest expense. This group ratio rule can be estab-

[13] OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report, pp. 47-54.

[14] DELOITTE, *OECD Tax Alert: BEPS Action 4: Interest Deductions and Other Financial Payments, International Tax*, October 2015.

lished separately or as an integral part of a general provision, comprising both fixed ratio and group ratio rules.

According to the group ratio rule, an entity exceeding the benchmark fixed ratio can deduct interest expenses up to the net third party interest/ EBITDA ratio of its group. Consequently, only the deduction of interest expenses that are above the levels provided by the fixed ratio rule or the group ratio rule will not be permitted.

With the objective of excluding entities that represent the lowest risk from the scope of the general interest limitation rule, the best practice approach suggests that a country may apply a de minimis threshold centered on the monetary value of the interest expense of all entities in the local group. In this case, no restrictions apply to the deduction of interest of entities that are below this limit.

The rules that relate interest deduction to EBITDA may raise questions when the interest expense of an entity and earnings arise in different tax periods. This may be a consequence of the volatility of earnings, which include the ability of an entity to deduct interest changes from year to year or because the entity has incurred interest expense to finance an investment that will only give rise to gains in a subsequent period[15].

This leads to problems where entities cannot deduct interest expenses incurred in other periods than in which earnings are realized as a result of a timing mismatch. To alleviate the impact of these problems, a country may allow entities to carry forward or carry back disallowed interest expenses or interest unused capacity. However, it is recommended that countries include limits on the application of these carry forwards and carry backs to tackle base erosion and profit shifting risks.

Regarding the recipients of these rules, Action 4 determines that the best practice approach, as a minimum, should be applied to all entities forming part of a multinational group. A wider application is also possible if including entities of a domestic group and/or standalone entities that are not part of a group[16].

[15] OECD, BEPS Action 4, 2015 Final Report, pp. 67-70.

[16] OECD, BEPS Action 4, 2015 Final Report, pp. 33-35.

An entity is considered to be part of a group, if it is directly or indirectly controlled by another company or if the entity constitutes a company that directly or indirectly controls one or more other entities. For a group to be considered multinational, it has to operate in more than one jurisdiction, including permanent establishments. Entities integrating multinational groups represent a higher risk in regards to base erosion and profit shifting. Nevertheless, a country can opt for the application of a broader fixed ratio rule to also include entities operating in domestic groups.

Countries are free to implement stricter standards than those proposed by the OECD for the purpose of combating base erosion and profit shifting or to achieve other fiscal policy objectives. Thus, the best practice approach can be complemented by general or specific interest limitation rules that a country considers adequate to mitigate the risks it may face.

4. Thin Capitalization Rules and Tax Treaty Law: The Arm's Length Approach

Article 9 of the OECD-MC provides the basis for tax treaty provisions concerning transfer pricing and establishes the use of the arm's length principle to treat transactions between associated companies as if they were conducted between unrelated parties.

Article 9(1) determines that the profits made by a company with its associated enterprises can be adjusted to the same level as what it would have earned if it had dealt with an independent company at arm's length. An adequate profit adjustment may be made in the debtor's state in conformity with Article 9 when the transaction between associated companies is not in accordance with the arm's length principle. In this way, Article 9(1) allows for amounts not in line with the arm's length principle to be included in a company's profit. Article 9(2) acknowledges a corresponding adjustment in the creditor's state of residence to prevent double taxation.

Under the arm's length principle, as a rule, interest is deductible, but non-arm's length interest is normally non-deductible and may receive a range of different treatments. In this context, three types of rules may be applied on a

national level: to establish an interest rate adjustment, according to which only a disallowance of the deduction is applied; to establish an interest-rate adjustment according to which the adjusted interest payment is reclassified as a distribution of dividends; or to establish a reclassification of the loan as an equity contribution[17].

According to the OECD Commentary on Article 9, Article 9(1) is relevant not only to test the arm's length nature of the interest rate, but also to assess whether a loan can, at first glance, be considered as equity for tax purposes[18]. Thus, the OECD has considered that Article 9(1) is also pertinent to the volume of the loan.

Furthermore, since it is widely accepted that tax treaties do not create tax responsibility, a legal base in the national laws is necessary to make profit adjustments among associated enterprises[19]. The legal basis in national law regarding thin capitalization rules can give rise to difficulties when, for example, a state makes a profit adjustment that is in conformity with the tax treaty and domestic law, but another state lacks national rules to make the corresponding adjustment. This situation could lead to double taxation.

Article 9 serves as the basis for the application of transfer pricing through tax treaties, and thus, the article can be regarded as a *lex generalis*.

Article 11 of the OECD MC allocates the right to levy taxes on interest payments. Under Article 11(6), it is possible to make a rate adjustment in cases where interest is deemed excessive, and it only applies where such excessive interest is paid due to a special relationship between the debtor and the creditor and only with respect to interest payments which exceed an arm's length payment for the debt-claim[20].

In this way, Article 11(6) constitutes a *lex specialis* with respect to Article 9[21]. Article 11(6) is a special rule that limits the application of Article 11. The

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[17] WIJNEN, «Thin capitalization rules and Tax Treaty Law», *cit.*, pp. 83-118.

[18] See para. 3 of the Commentary on Article 9 of the OECD Model.

[19] LANG, *Introduction to the Law of Double Taxation Conventions*, Wien, Linde Verlag, 2010, p. 32.

[20] Para. 33 of the Commentary to Article 11 OECD MC.

[21] VOGEL, *Double Taxation Conventions*, London, Kluwer Law International, 1996, pp. 518-519 and 758.

intention of Article 11(6) can be acknowledged in the Introductory Report of the Draft OECD MC of 1963, which describes the provision as a safeguard clause dealing with excessive interest payments[22].

The goal of Article 11(6) is related to the extensive treaty definition of interest contained in Article 11(3). Within this broad definition and in the absence of Article 11(6), states would not be able to refuse the classification of an excessive interest payment as an interest payment even if it exceeded the arm's length payment of interest. If Article 11(6) was not included in a tax treaty, states would have to continue to treat excessive interest payment as an interest payment, since it would be covered by the definition provided by Article 11(3)[23].

In the context of tax treaty law, the definitions of dividend and interest have proven to be relevant for the application of other provisions of the treaty. With respect to tax treaty law and national thin capitalization rules, the OECD's view is that Article 10(3) does not preclude a reclassification of interest due to thin capitalization rules[24]. However, the reclassification is allowed only to the extent that the lender effectively shares the risks incurred by the debtor company on a particular loan. Considering that this criterion is fulfilled, the reclassified payment may be treated as income from "other corporate rights", falling under Article 10(3).

The debtor state which applies thin capitalization rules can consider the excessive amount as dividend for all treaty purposes or it may simply not allow the deduction of excessive interest and continue to treat the payment as interest. Regarding the creditor state, it may either agree with the disallowed interest deduction or reclassified interest payment made by the debtor state providing relief from double taxation, or it can refuse the adjustment or reclassification and, in this case, double taxation may occur[25].

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[22] Introductory Report to the OECD Draft double taxation convention on income and capital 1963, General remarks and brief analysis of the Convention, para. 19.

[23] VALENCIA, «Tax Treatment of Intra-Group Interest in the Context of Art. 11 OECDMC», in *International Group Financing and Taxes*, Wien, Linde, Vol. 74, pp. 409-435.

[24] WIJNEN, «Thin capitalization rules and Tax Treaty Law», *cit.*, pp. 83-118.

[25] SCHON, «General Report», in *IFA, The tax treatment of interest in international economic transactions, Cahiers de droit fiscal international*, Vol. 67a, 1982.

The criterion to determine if the treaty definition of dividend referred to in Article 10(3) includes a reclassification also requires the creditor state, in principle, to accept the national thin capitalization rules of the debtor's state when the creditor shares the risks incurred by the debtor company.

This position and the subsequent treatment that should be given by the lender State is included in the OECD Commentary which states that, when the condition of sharing the risks is met, the reclassified amount may be taxed by the debtor state as a distribution of dividends where the amount is included in the taxable profits of the debtor[26]. Accordingly, the lender state has to provide relief from double taxation as if the reclassified amount were in fact a dividend distribution. The structure of the treaty, therefore, allows adjustments and re-classifications respecting the limits of the arm's length principle and expects that the creditor state will accept those in a similar manner.

The vision of the OECD regarding the acceptance by the creditor state of the adjustments made by the debtor state based on national thin capitalization rules is not embraced by all creditor states. Research has shown that lender states generally do not feel bound by the reclassification made by the debtor state and, as such, continue to treat the payment as interest for national tax purposes[27].

This position of creditor states may give rise to double taxation, but, here the issue of double taxation is not considered very significant. Many states do not reclassify the non-arm's length interest payments; instead they do not allow a deduction from the debtor's profits. In the EU, for example, reclassified interest payments are not subject to dividend tax withholding as a result of the Parent and Subsidiary Directive.

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[26] Paras. 67 and 68 of the Commentary to Article 23 A and B of the OECD MC.

[27] HINNY, «General Report», in *IFA, New tendencies in tax treatment of cross-border interest of corporations, Cahiers de droit fiscal international*, Vol. 93b, 2008, p. 43.

5. Thin Capitalization Rules and EU Law

The TFEU contemplates five fundamental freedoms, which include the free movement of goods (Article 28 *et seq.*), the free movement of workers (Article 45), the freedom of establishment (Article 49), the free movement of services (Article 56), and the free movement of capital (Article 63), to meet the target of a common internal market[28]. The fundamental freedoms, which are likely to be associated with thin capitalization rules, are the freedom of establishment and the free movement of capital.

The CJEU has interpreted the freedom of establishment to apply in cases where the shareholder or investor exerts a significant influence on the decisions of an enterprise, allowing him/her to define the activities of the company[29]. In the context of the free movement of capital, the CJEU has interpreted it as applicable in situations where an investor, through a shareholding or the acquisition of securities on the capital market, has a direct investment that takes the form of participation in a company[30].

The CJEU has issued some decisions with regards to national thin capitalization rules that have been adopted by member states. In those cases, the CJEU has examined (i) the possible infringement of the fundamental freedoms envisioned in the TFEU; (ii) the presence of discrimination or restrictions as a consequence of the application of national thin capitalization rules; (iii) the existence of justifications for the use of such provisions and; (iv) the proportionality of the measures established by national legislation.

The first decision of the CJEU to address the issue of the compatibility of domestic thin capitalization rules with EU law was issued in the *Lankhorst-Hohorst* case and influenced equivalent rules in other EU Member States.

In the *Lankhorst-Hohorst* judgment of 12 December 2002, the CJEU held that the initial German thin capitalization provisions were inconsistent with the

[28] Consolidated Version of the Treaty on the Functioning of the European Union of 26 October 2012, Official Journal of the European Union, C 326/47.

[29] ECJ, 13 April 2000, Case C-251/98 Baars [2000] I-2787, para. 22.

[30] ECJ, 13 May 2003, Case C-98/01 Comission v United Kingdom [2001] I-4641, para. 39. See, also, ECJ, 16 March, 1999, Case C-222/97 Trummer and Mayer [1999], I-1661, paras. 20-21 and ECJ, 2 June 2005, Case C-174/04 Commission v Italy [2005] I-4933, para. 27.

freedom of establishment in accordance with Article 49 of the TFEU. Specifically, the CJEU found that the German thin capitalization rules gave rise to a different treatment between resident subsidiaries depending on whether or not their parent company had its seats in Germany, and that this represented a barrier to the freedom of establishment. The German rule provided that the important requirement to reclassify the payment of interest as a profit distribution was if the shareholder who received the loan repayment was allowed a corporate tax credit or not, and, as a rule, resident parent companies were entitled to a tax credit, while non-resident parent companies were not[31].

In this way, the interest paid to a non-resident parent company was always taxed at a 30% rate, while the interest paid on loans provided by a resident parent company was considered an expense[32]. This represented a restriction to the freedom of establishment by making it less appealing for companies based on other Member States to establish a subsidiary in Germany[33].

The CJEU rejected the argument that this different treatment was justified by the risk of tax evasion, given that the provision did not pursue the specific objective of avoiding artificial arrangements, but it was rather applicable to all cases involving parent companies whose residence was not in Germany. The Court added that this situation does not pose a risk of tax evasion since the parent company that is not domiciled in Germany will still be taxed in its country of residence[34]. Moreover, the ECJ rejected the above-mentioned justification because no evasion has been proven.

In this case, the CJEU refused the arguments made by the German government that the thin capitalization rules did not give rise to discrimination on the grounds of nationality, that they were created to deter tax evasion, and that they were legitimized by the need to guarantee the coherence of the tax system and the efficiency of fiscal supervision.

On the basis of the criteria followed by the CJEU in the *Lankhorst-Hohorst* case, various groups of resident subsidiaries in the United Kingdom claimed

[31] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst [2002] I-11779, paras. 28 and 4.
[32] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst [2002] I-11779, para. 29.
[33] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst [2002] I-11779, para. 32.
[34] ECJ, 12 December 2002, Case C-324/00 Lankhorst-Hohorst [2002] I-11779, para. 37.

restitution and compensation for the tax disadvantages that have arisen as a result of the application of the UK thin capitalization rules. One factor that these cases had in common was that each group of companies included a resident company in the UK which was at least 75% owned, directly or indirectly, by a non-resident parent company and had been provided a loan either by that parent company or by another non-resident company which was at least 75% owned, directly or indirectly, by the same parent company[35].

The High Court of Justice of England and Wales questioned if national rules which limit the capacity of a company resident in a Member State (MS) to deduct interest on loans provided by a direct or indirect parent company resident in another MS, in circumstances in which the debtor company would not be exposed to such restrictions if the parent company was resident in that same state, constituted an infringement to the freedom of establishment, the free movement of services and/or the free movement of capital.

In the *Thin Cap Group Litigation* judgement of 2007, the CJEU held that the freedom that was mainly affected was the right of establishment as all the cases were linked to companies in which at least 75% of the shares were held by a non-resident parent company[36] and, as such, the creditor exerted decisive control over the debtor. The Court added that any limitation to the free movement of services and capital was an inevitable result of the restriction on the freedom of establishment, which did not justify a separate analysis of these freedoms[37].

The CJEU in this case also found that the difference in treatment between resident subsidiaries according where their parent company had its headquarters represented a restriction to the freedom of establishment, as it made it less appealing for companies based on other MS to exercise their freedom of establishment[38].

In this judgment, the CJEU accepted, for the first time, the justification for thin capitalization rules to prevent and fight tax avoidance, considering the arm's length principle as a proper and equitable test of artifice.

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[35] ECJ, 13 March 2007, Case C-524/04 Thin Cap Group Litigation [2007] I-02107, para.17.

[36] ECJ, 13 March 2007, Case C-524/04 Thin Cap Group Litigation [2007] I-02107, paras. 32-33.

[37] ECJ, 13 March 2007, Case C-524/04 Thin Cap Group Litigation [2007] I-02107, paras. 34-35.

[38] ECJ, 13 March 2007, Case C-524/04 Thin Cap Group Litigation [2007] I-02107, para. 36.

The CJEU also considered the proportionality of the provisions relating to thin capitalization, that is, if they do not go further than what is needed to prevent abuse, suggesting that they are regarded as such when they allow taxpayers to demonstrate the economic substance of the operations, and when the only amount that is re-characterized, as dividends is the one that does not correspond to the interest that would have been paid under the arm's length principle[39].

In the *NV Lammers & Van Cleef* case, the CJEU stated that the Belgian legislation provided a different tax treatment to the interest paid by a resident company according to whether or not its director is a resident in Belgium. The Belgian legislation allowed the reclassification of interest as a profit distribution and taxed it as such only in cases where the director is a non-resident company and the interest is deemed excessive under the limits provided for in the Tax Code. Conversely, when the director is a resident company, the interest is not reclassified as a distribution of profits, even if it is regarded as excessive. In this way, non-resident companies that are directors of a Belgian company face a less favourable tax treatment[40].

In this case, the CJEU concluded that the difference in treatment between resident and non-resident directors of a Belgian corporation constituted a restriction to the freedom of establishment and held that such limitation went beyond what was required to meet the goal of preventing abusive practices, given that it could impact operations which cannot be regarded as artificial.

In the *Itelcar* case, the CJEU considered the Portuguese thin capitalization rules applied between resident companies and companies from third (non-EU) countries, which are regarded as related parties, as contrary to the free movement of capital[41]. The CJEU ruled that the Portuguese provisions intended to prevent a resident company from obtaining credit in a way deemed excessive from a company resident in a third country. The CJEU accepted the argument of the Portuguese Government on the need of the rule to deter tax avoidance

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[39] ECJ, 13 March 2007, Case C-524/04 Thin Cap Group Litigation [2007] I-02107, paras. 78-83.

[40] ECJ, 17 January 2008, Case C-105/07 NV Lammers [2008] I-00173, paras. 20-24.

[41] GLOBAL TAX ALERT EU COMPETENCY GROUP, «The CJEU finds Portuguese thin capitalization rules contrary to free movement of capital», 10 October 2013.

and evasion. However, the Court indicated that the rule went beyond what is necessary to achieve this goal and thus, considered it inconsistent with EU law[42].

Some countries like Denmark, Germany, Italy, Portugal, Spain and the United Kingdom have adapted their thin capitalization rules to be in line with the decisions issued by CJEU[43].

Following the CJEU decision in the *Lankhorst-Hohorst* judgement, various Member States amended their provisions on thin capitalization rules. The approach followed by the member states to conform to EU legislation was essentially to broaden the scope of thin capitalization rules so as to include the loans that were signed between resident corporations – Denmark and the Netherlands opted for this approach; or to exclude intra-EU loans from the scope of thin capitalization provisions – Spain (until 2012) and Portugal chose this approach.

Germany, for instance, adopted earnings stripping rules, under which the deductibility of interest expenses on loans with related and unrelated parties is limited to 30% before EBITDA and applies to both resident and non-resident creditors[44]. Any interest expenses which exceed this limit are not deductible, but they can be carried forward and deducted in subsequent years when they will again be subject to interest barrier rules.

The UK, following an entirely different approach, chose to revoke its thin capitalization rules and alternatively applied transfer pricing rules to transactions that fell within their scope. As a result, taxpayers are no longer required to have their debt-to-equity in a ratio established by a national thin capitalization rule, but rather to carry out all their operations at arm's length considering that

[42] ECJ, 3 October 2013, Case C-282/12 Itelcar [2013], paras. 36-40

[43] TERRA & WATTEL, *European Tax Law*, 5th ed., Alphen aan den Rijn, Kluwer Law International, 2008, p. 585.

[44] However, the earnings stripping rule is not applicable either to smaller sized businesses that incur net expenses below the amount of EUR 1,000,000, or to a business that does not belong totally or partially to a group.

only the amount of interest that is not in accordance with this principle is treated as not deductible[45].

This system is applicable to transactions which relate to both resident and non-resident creditors and seems to comply with EU law and the CJEU decisions, as was stated by Advocate General Geelhoed in the Thin Cap Group Litigation judgment[46].

Portuguese thin capitalization rules were introduced in January 1996. When the levels of debt of a Portuguese taxpayer in relation to a non-resident entity in Portugal (or in an EU country with whom special relations exist) is deemed excessive, the interest paid in relation to the part of the debt considered excessive will not be deductible for the purposes of assessing taxable income.

Before the reform, excessive debt was considered to occur when the value of the debt in relation to each of the entities is more than twice the value of the corresponding shareholding in the taxpayer's equity (2:1 debt-to-equity ratio). With the reform, the Portuguese thin capitalization rules were tightened. Particularly, under Article 63 of the Portuguese Corporate Income Tax Code (CIRC), the deductibility of net financial expenses is limited to 1 million EUR or 30% of EBITDA, regardless of whether the parent company of the resident subsidiaries is a national or foreign one.

Despite member states following different thin capitalization approaches, one thing that they have in common is that their legislation has to be in conformity with EU law.

A member state which has not yet adjusted its thin capitalization rules to be in accordance with the CJEU's criteria should do it to avoid any consequences, such as the filing of complaints against the MS and the resulting obligation to refund the taxes paid as a result of the application of thin capitalization provisions that are incompatible with the fundamental freedoms of the EU.

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[45] GREEN, «U.K. Thin Capitalisation: After the Renovations», in *BNA International's Tax Planning International Transfer Pricing*, September 2004.

[46] Opinion of Advocate General Geelhoed, 29 June 2006, Case C-524/04 Thin Cap Group Litigation [2007] I-02107, point 44.

6. Potential Negative Impact of Thin Capitalization Rules on Levels of Investment

In terms of their effectiveness, thin capitalization rules, in fact, appear to have decreased debt ratios[47]. However, there are some economic studies which establish that the imposition of constraints on particular forms of international tax planning may result in unfavourable consequences with respect to investment made by international groups in countries which apply high tax rates[48].

In this context, it is pertinent to consider the cases of foreign subsidiaries that finance their operations with internal debt usually granted by low-tax related parties and, as a result, enjoy a comparatively low tax burden. When a thin capitalization rule is introduced, companies that heavily rely on debt finance will face a situation of excessive debt, that is, debt exceeding the threshold determined by the debt/equity ratio. Consequently, a part of the interest deduction will be disallowed, and there will be an increase in the tax burden as a result. This may decelerate foreign direct investment[49]. Also, even if companies opted to reduce their internal debt finance levels, the tax burden would also increase, given that companies would be applying less tax-efficient financing.

In the presence of a thin capitalization provision, when there is an increase in the tax rate, the tax shield from internal debt financing is less efficient for companies with limited deductibility of interest. As a result, there will be an increase in the tax burden, and the tax sensitivity of foreign direct investment may increase when a thin-capitalization rule is introduced. Such policies are also considered to possibly enhance tax competition[50].

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[47] OVERESCH & WAMSER, «Corporate Tax Planning and Thin-Capitalization Rules: Evidence from a Quasi Experiment», in *Applied Economics*, 2008.

[48] PERALTA *ET AL.*, «Should countries control international profit shifting?», in *Journal of International Economics*, 68, 2006, pp. 24-27.

[49] BUETTNER, OVERESCH & WAMSER, «Anti Profit-Shifting Rules and Foreign Direct Investment», CESifo working paper no. 4710, March 2014.

[50] See PERALTA *ET AL.*, «Should countries control international profit shifting?», *cit.*, pp. 24-27.

Companies that do not use much internal debt are usually below the debt/equity ratio, and any deduction of interest is, in principle, not denied. In this way, the introduction of thin-capitalization rules would not affect those companies. However, studies seem to suggest that it is more likely to find companies that are subject to limitation of interest deduction in countries that apply higher tax rates. Accordingly, some authors have considered that the introduction of thin capitalization rules may have negative effects on foreign direct investment, especially in countries that apply high statutory tax rates[51].

Despite the rise of some preoccupation over the impact of thin capitalization rules on levels of investment, recent studies have not succeeded in establishing, in pragmatic terms, a direct correlation between thin capitalization rules and investment levels[52].

7. Possible Alternatives to Thin Capitalization Rules

The fact that many member states confer a different tax treatment to interest and dividends constitutes the main reason that some multinational groups opt to finance their affiliates by means of debt rather than equity capital. This led to the need to create thin capitalization rules.

Against this background, some authors have argued that the best solution to prevent the erosion of the MS's tax base is to give a neutral treatment to both debt and equity financing, meaning that the need to adopt tax schemes to obtain tax advantages will no longer exist and, consequently, it will not be necessary to design anti-aggressive tax planning rules to address this matter. This would also mean that concerns regarding the compatibility of such rules with EU law would cease[53].

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[51] BUETTNER, OVERESCH, SCHREIBER & WAMSER, «The Impact of Thin-Capitalization Rules on Multinationals' Financing and Investment Decisions», CESifo working paper no. 1817, October 2006.

[52] DOURADO & LA FERIA, «Thin Capitalization Rules in the Context of the CCCTB», Oxford University Centre for Business Taxation, 2008.

[53] BRAVO, «Thin Capitalization Rules and EU Law/Fundamental Freedoms», *cit.*, pp. 119-143.

Two alternatives are suggested regarding the design of corporate tax systems to remove the distortion caused by the different treatment that is given to debt and equity financing by dealing with both sources of funding in the same manner: an Allowance for Corporate Equity (ACE) or a Comprehensive Business Income Tax (CBIT). The ACE would allow a deduction for return on equity (as in the case of interest payments) and would consequently mitigate or eliminate the tax benefits of debt finance. The CBIT system, in turn, would deny the deduction of interest for corporate income tax purposes. The common factor in these systems is that they are both intended to counteract the distortionary impact of corporate taxes on the financial structure of companies.

Recently, the CBIT and the ACE have raised interest in the EU policy debates as a possible path to readjust corporate tax systems[54]. Some countries have experienced or implemented changes in their tax laws with characteristics similar to the ACE system. The majority of countries have established limits on the deduction of interest which further resembles the CBIT[55].

7.1. *CBIT*

The CBIT aims to remove the advantageous tax treatment given to investment that is financed with debt, by proposing the disallowance of the deduction of interest payments. In 1992, the US Treasury suggested the CBIT, and its proposal provides an important distinction between CBIT entities and non-CBIT entities[56].

In principle, most companies will classify as CBIT entities (only small companies will not), which are not allowed interest deductions. To prevent double taxation of interest, it should be given a tax exemption or credit to interest received by companies from other CBIT entities. However, if the interest payment

[54] MOOIJ & DEVEREUX, «Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT Reforms», Oxford University Centre for Business Taxation, 2008.

[55] See, for example, MOOIJ & DEVEREUX, «An Applied Analysis of ACE and CBIT Reforms in the EU», in *International Tax and Public Finance*, Vol. 18, Issue 1, February 2011, pp. 93-120, published online: 3 June 2010.

[56] «Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Once», Jan. 1992.

comes from a non-CBIT entity, it will be exposed to tax. Interest that is received from abroad, in principle, will be subject to tax, however, if the interest received comes from a CBIT entity, it should be tax exempted or credited[57].

The CBIT has the effect of increasing the cost of capital for a debt-financed investment because the interest paid is no longer deductible when calculating the tax base. Although[58] this reform leads to an increase in the capital cost, it might be recommended for a country to apply it if, at the same time, the country adopts a lower corporate tax rate since the tax base is now broader.

The CBIT removes distortions in the financial structure of companies, but it increases the cost of capital when investments are financed by debt. The latter may have the result of reducing investment but, at the same time, since the CIT base will be broader, it will allow a reduction in the CIT rate as part of a revenue-neutral reform. Hence, the tax burden on profitable equity financing will be reduced. Additionally, a decrease in the corporate income tax rate will also make a country more appealing for foreign direct investment.

In 2007, Sorensen found that, in general, the effect of the CBIT is unclear: on one hand, the cost of capital for low-income debt financed investments is likely to rise, which may represent a decrease in investments; on the other, highly profitable equity financed investments will be less taxed so these investments will probably expand[59]. Following Bond (2000), the advantages arising from lower tax rates under CBIT will presumably compensate for the costs incurred due to a higher cost of capital[60].

Until now, there are no practical examples of the CBIT system and according to Mooij, its implementation can possibly result in transitional problems

[57] HUBBARD, «Corporate Tax Integration: A View from the Treasury Department», in *Journal of Economic Perspectives*, Vol. 7, No. 1, 1993, pp. 115-13.

[58] GRAHAM, «Do Corporate Taxes (and Interest Deductibility) affect Corporate Decisions», Presentation at IMF Technical Workshop on Tax-Induced Debt Bias, 4 March 2011, Washington DC.

[59] SØRENSEN, «Can capital incomes taxes survive? And should they?», in *CESifo Economic Studies 53*, pp. 172-228.

[60] BOND, «Levelling Up or Levelling Down? Some Reflections on the ACE and CBIT Proposals, and the Future of the Corporate Tax Base», in S. Cnossen (ed.), *Taxing Capital Income in the European Union*, Oxford University Press, Oxford, 2000.

and practical adversities, for example, difficulties in treating pre-existing debt[61]. In this way, the implementation of such a system should be gradual and take place over a long period of time.

A partial application of the CBIT to intra-group debt financing may be effective in reducing the levels of debt shifting by multinational companies, although it implies coordination between countries. Hence, states would consider all intra-group financial flows as equity and tax their returns accordingly. Therefore, international groups would no longer be able to shift their profits through debt across jurisdictions.

Nevertheless, if the CBIT system is unilaterally applied, this could aggravate international debt shifting as companies would stop financing their investments with debt in countries that apply this system since the deductibility of interest is not allowed. Companies would rather finance their investments in the countries that do not apply the CBIT with debt which derived from countries that apply the system (given that interest payments are usually not taxed)[62]. In addition to this, it may give rise to double taxation in cases where countries do not allow foreign tax credits or exemptions for interest payments arising from CBIT countries.

7.2. *ACE*

The ACE system was initially suggested by the Capital Taxes Committee of the Institute for Fiscal Studies in 1991. The system rests on an earlier idea developed by Boadway and Bruce in 1984, who proposed an allowance for corporate capital (ACC)[63]. The authors' suggestion was to eliminate the deduction of actual interest payments and to substitute it with an allowance of the normal

[61] SHAVIRO, "The 2008 Financial Crisis: Implications for Income Tax Reform", forthcoming in J. Alworth and G. Arachi (eds.), *Taxation Policy and the Financial Crisis*, Oxford University Press, 2011.

[62] MOOIJ & DEVEREUX, «Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT Reforms», *cit*.

[63] BOADWAY & BRUCE, «A General Proposition on the Design of a Neutral Business Tax», in *Journal of Public Economics*, 1984, pp.231-239.

return, applied to the book value of all the company's capital according to the tax accounts.

The ACE lightly differs from the ACC as it continues to allow the deduction of interest payments. In addition to the deduction of interest, a notional return on equity would also be deductible against companies' profits.

The ACE is perceived to have some appealing characteristics. One important feature is that it achieves neutrality between debt and equity financing. Therefore, the ACE renders thin capitalization rules inessential[64].

Another feature of this system is its neutrality on the subject of marginal investment decisions. Since the ACE allows a deduction for both interest and the normal rate of return on equity, it is not intended to tax capital income. In this sense, the system is intended to only tax economic rents, and no tax would be levied on investments whose return corresponds to the cost of capital[65].

Even though the ACE is more neutral than present corporate tax regimes with respect to investment and its financial structure, it also includes some disadvantages. In particular, the ACE has the effect of narrowing the tax base (since deduction on equity is now allowed) which would imply a decrease in corporate tax revenue collected by states[66]. As a result, states would probably apply higher taxes elsewhere to compensate for this revenue loss and to balance the government budget. One possible option would be to increase the corporate tax rate.

In this context, the ACE would transfer the tax burden from marginal return to capital to economic rents. If one considers a closed economy, which is characterized by a perfect capital market, the tax system would not be distortionary. However, inasmuch as the economies are open, rents can be mobile. For example, specific rents of companies related to brands or patents may be

[64] KLEMM, «Allowances for Corporate Equity in Practice», IMF working paper, Fiscal Affairs Department, November 2006.

[65] MOOIJ & DEVEREUX, «Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT Reforms», *cit*.

[66] FATICA, HEMMELGARN & NICODÈME, «The Debt-Equity Tax Bias: Consequences and Solutions", working paper no. 33-2012, July 2012.

shifted across countries. Hence, the move from capital to rents would influence the production location[67].

The ACE system also seems to impact investment decisions when companies encounter credit constraints. In particular, these restrictions are applicable to new and innovative companies which still do not have a reputation. Assuming that these companies cannot get credit from banks or investors, they will depend on retained earnings to finance their new projects. Hence, an increase in the corporate tax rate would not benefit such companies since it will decrease cash flow and liquidity of companies[68].

The ACE might be considered undesirable with respect to international profit shifting. There are several options which are made available for multinational groups to shift profits across jurisdictions. Because countries apply different statutory tax rates, international profit shifting techniques are exploited by states. Since an ACE is only advantageous for states' revenue when accompanied by an increase in statutory tax rates, the government is likely to lose revenue through the application of profit shifting strategies towards other countries[69].

It is important to note that the ACE system does not necessarily imply an increase in the corporate tax rate. An increase in the tax on consumption, for instance, may be another candidate to make up for the revenue costs of the ACE. In this way, the economic consequences of an ACE system may be different if this alternative way to balance the government budget is applied.

International tax planning by means of intra-group loans might also change, given that debt and equity would receive a more neutral treatment according to the ACE system. In this way, if all countries adopted this system, multinational companies would no longer feel motivated to adapt their intra-group debt-to-equity ratios. Conversely, if the ACE system is adopted by only

[67] BOND, «Levelling Up or Levelling Down?...», *cit.* See, also, DEVEREUX & GRIFFITH, «Taxes and the Location of Production: Evidence from a Panel of U.S. Multinationals», in *Journal of Public Economics 63*, pp. 335-367.

[68] MOOIJ, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, IMF, 3 May 2011.

[69] MOOIJ & DEVEREUX, «Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT Reforms», *cit.*

one country, international groups may have an incentive to locate their equity in that country since equity returns would not be fully taxed[70]. If the distribution of dividends is exempted in the country of the parent company, it makes it appealing for multinationals to channel equity to the ACE country and decrease their overall tax burden.

Various countries have experienced some variants of the ACE system. Croatia, Austria and Italy implemented variants of the ACE, but they were subsequently brought to an end. However, according to Keen and King (2002), this was not due to administrative or technical difficulties[71]. The abolition of the ACE was rather part of a reform directed at decreasing the corporate income tax rates. Klemm (2007) indicates that these ACE reforms have been linked to a reduction in debt/equity ratios[72]. At present, Brazil, Latvia and Belgium apply some variations of the ACE.

Brazil has introduced the concept of "interest on net equity" ("INE") into its corporate income tax system. Shareholders may be remunerated either through the payment of dividends, which are not deductible for corporate income tax purposes, or through the INE. INE paid to shareholders is deductible for purposes of corporate income tax, subject to the following limits: "(a) the official long-term interest rate times accounting net equity, and (b) 50 per cent of taxable income, before the deduction of INE"[73].

In 2006, Belgium adopted the notional interest deduction (NID), which establishes an interest deduction with respect to equity financing, regardless of whether dividends are paid. The deduction corresponds to the interest rate on 10-year Belgian state bonds multiplied by the amount of the company's net assets. Although the goal of the NID is to narrow the different treatment of debt and equity financing, such differences persist due to differences in the treatment of interest and dividends received by investors[74].

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[70] *Id.*

[71] KEEN & KING, «The Croatian Profit Tax: An ACE in Practice», *Fiscal Studies 23*, 2002, pp. 401-18.

[72] KLEMM, «Allowances for Corporate Equity in Practice», in *CESifo Economic Studies 53*, 2007, pp. 229-262.

[73] BROWN, «General Report», in *IFA cahier*, Vol. 2, 2012, p. 39.

[74] *Id.*

The economic implications of ACE reforms remain slightly unclear. Not only is there insufficient information provided, but it is also difficult to assess the ACE individually since in most cases, it was part of a multiple reform[75].

7.3. *ACE and CBIT combinations*

In theory, there can be a combination of the ACE and CBIT systems. For example, Italy and Austria, in their experiments, did not exempt normal economic profits from taxation, but rather applied a lower tax rate on such profits than on economic rents[76]. Hence, these systems can be typified as partial ACE systems. In the same way, reforms which establish restrictions on the deduction of interest, such as thin capitalization rules or earnings stripping rules, can be seen as partial CBIT reforms.

The discrimination between debt and equity can be reduced by a combined reform of a partial ACE and a partial CBIT[77]. Simultaneously, the implications for corporate tax revenue should be counterbalanced. Consequently, the optimal combination would include a reform package of a partial ACE and partial CBIT, which is revenue neutral for the states and even more neutral in relation to the companies' financial structures.

Determining an ideal combination of ACE and CBIT is very difficult. To achieve optimality, not only would financial distortions have to be reduced, but distortions of the corporate income tax, including location distortions, investment distortions, and aggressive tax planning via profit shifting, would also have to be reduced[78]. Different countries have varying levels of distortions. Therefore, optimality rules will differ accordingly.

Furthermore, these distortions depend on how countries draft their systems. They could do so unilaterally or multilaterally. An economic perspective regarding optimality conditions may indicate that some countries will consider

[75] See, for example, MOOIJ & DEVEREUX, «An Applied Analysis of ACE and CBIT Reforms in the EU», *cit.*

[76] *Id.*

[77] FATICA, HEMMELGARN & NICODÈME, «The Debt-Equity Tax Bias: Consequences and Solutions», *cit.*

[78] MOOIJ & DEVEREUX, «An Applied Analysis of ACE and CBIT Reforms in the EU», *cit.*

it optimal to shift the tax burden to other tax bases. For example, an ACE can be financed by a rise in labour or consumption taxes. Countries might reduce their corporate tax rates and cut back transfers, achieving effectiveness in this way.

It is, however, not only a question of effectiveness. Equity issues have to be taken into account when questioning if such policies are socially advantageous or even alluring. To reach optimality, it is necessary to get a full assessment of key trade-offs between equity, efficiency, and administrative feasibility.

8. Conclusions

The different tax treatment between equity and debt finance gives multinational companies opportunities for tax arbitrage on an international level. Tax arbitrage is essentially the process of taking advantage of the differences in the tax rates applied by countries and is only achieved because the country of the lender applies a more advantageous tax rate than the country of the borrower. If this is the case, international groups naturally opt for debt-financing rather than equity financing to decrease the group's general tax burden by shifting income from high-tax jurisdictions to low-tax ones via debt-financing.

This results in the erosion of the corporate tax base of the borrower's country and, thus, thin capitalization rules and earnings stripping rules are generally considered to be effective measures to combat financial structures that are excessively leveraged. To counter the debt bias problem, the most popular reaction has been the adoption of thin capitalization rules not only within the EU, but also among OECD countries.

The OECD has completed extensive work on the matter of international tax avoidance, specifically through the BEPS project whose Action 4 recommendations assumed particular importance for this research.

In the EU context, some of the thin capitalization rules adopted by MS were considered incompatible with the EU fundamental freedoms and, as a result, a number of member states have adapted their thin capitalization rules to conform with the EU law.

Although some studies suggest that the adoption of thin capitalization rules may have a potential negative impact on investment in high-tax jurisdic-

tions, introducing these rules has positive effects in curtailing international tax planning through debt financing. Their implementation will protect the tax base, and consequently the revenue. Also, not including rules that put a limitation on the interest deduction could give rise to many more economic distortions.

However, what some authors have been suggesting is that the real solution to prevent the erosion of the tax base is to eliminate the different treatment applied to interest and dividends. The application of a neutral tax treatment to debt and equity financing would alleviate the need to create tax schemes to obtain tax advantages from the use of debt financing.

With the aim of neutralizing the divergent treatment given to debt and equity, two alternatives were suggested: the ACE and the CBIT systems. The ACE would allow for a deduction for return on equity (as in the case of interest payments) and would, consequently, mitigate or eliminate the tax benefits of debt finance. The CBIT system, in turn, would deny the deduction of interest for corporate income tax purposes.

These systems appear to have some appealing features, but there are also some drawbacks associated with them. These should be counterbalanced to assess the effectiveness of the systems. A possible combination between a partial ACE system and a partial CBIT system appears to be an attractive idea, but there is still research that remains to be done on this subject.

A reform in the tax systems aimed at ending with the discrimination between the two sources of financing seems an interesting and feasible idea, but more direct evidence on its plausibility should be provided since some implications are liable to derive from this reform.

Given the present context and the universal effort made in the direction of thin capitalization rules, their adoption seems to be the most pragmatic solution in the short run. Furthermore, it seems that they are, in fact, effective in reducing debt-to-equity ratios and tax avoidance and that their life expectancy is still long. Although countries may undertake reforms towards more neutrality, I believe that it will always be convenient for them to have rules that limit the deduction of interest, that is, rules that help governments to prevent the erosion of the tax base.

In the same way that interest is the cost of doing business, so is the injection of capital into a company until the moment that the capital cost is recovered. In my view, the amount of equity return that corresponds to the cost of capital or cost of financing should also be considered as the cost of doing business and, as such, this amount (like interest) could be deductible up to a pre-established threshold.

The question remains as to whether this discrimination between the two forms of financing is justified and why an investment financed via debt should receive a more favourable tax treatment than one that has been financed through equity capital.

AML/CFT Regulations of EU in the Age of Virtual Currency

Elif Nazli Birgi *

Introduction

Global consideration on money laundering has its origins in the narco-trafficking of the 1980s, which raised public awareness and took international regulatory body's attention. Throughout time, due to the socio-economic and political context, legislations on money laundering were transformed to introduce an efficient response to new challenges. As needed in the aftermath of 9/11, counter-financing of terrorism (CFT) was included in the scope of anti-money laundering (AML) legislations, due to the intertwined nature of these two criminal matters. A new challenge to the AML/CFT legislations was introduced by the technological developments and the emergence of virtual currency. Identification of the new challenge, just like the previous ones that appeared, forced national and regional legislative bodies to transform their anti-money laundering laws once again.

Virtual currency, more specifically cryptocurrency[1], emerged as a peer-to-peer electronic payment system eliminating the electronic medium. Its creation was a result of the financial crises of 2008, which reduced individual confidence in financial institutions and the services they provide. Appearing as an alternative, fast, easy and cheap non-cash payment method as compared to the traditional electronic payment systems, its usage became widespread within a short notice.

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* LLM in European and Transglobal Business Law, University of Minho (Braga, Portugal).

[1] A type of virtual currency which can be used to purchase real goods and services of the market. The way of operation of crpytocurrencies are decentralized, hence there is no authority that issues, controls and monitors the currency. Furthermore, the currency allows users to keep themselves anonymous.

Along with its benefits, the system is not invulnerable to risks. Despite the transparency of the transfer of funds, sales through anonymous digital wallets and elimination of a third trusted party enable launderers to conceal the origins of illegally obtained money and hardens the surveillance of the money flow. Additionally, its international transmissibility allowing access through internet and cross-border transfers increases the risks related to money laundering and terrorist financing.

Despite its widespread use and invulnerability to risks, it operated free from regulation for a long time. However, regulators took notice of the issue after facing various cases, namely Liberty Reserve, Silk Road and Western Express International, involving the use of virtual currency for the purpose of criminal activities like drug trafficking, armament and fraud. Furthermore, some Bitcoin wallets were found that were related to some terrorist groups in the Gaza Strip and to Daesh to fund their activities. Responses were varied and distinct to these risks. While some countries opted to ban trade in virtual currency (China), others opted to issue licenses to the virtual currency exchangers[2] (New York State Department of Financial Services-BitLicense), subjecting them to specific requirements with the purpose of reducing client anonymity.

The European Union, taking its powers for regulating criminal matters from the Treaty of the Functioning of European Union (TFEU), proposed an amendment to the 4th AML, with the purpose of reducing anonymity of virtual currency. Not yet accepted, its ability to produce an adequate response to challenges, due to the special nature of virtual currency, is questionable.

This paper aims to study the EU's Anti-Money Laundering Legislation and its application to Virtual Currency, with particular attention to cryptocurrency due to its decentralized and universal nature. In order to carry out research, it is based on the main research question: "Is current AML/CFT Law of the European Union adequate in dealing with virtual currency?".

Assessment will be done by taking into account special characteristics of virtual currencies attributable to the risks: anonymity, international transmissibility and decentralization, and answering the question of whether or not these

[2] According to the definition of FATF Report, exchanger is a person or entity engaged as a business in the exchange of virtual currency for real currency.

characteristics received a response from the proposal directive on AML. Instead of solely defining what virtual currency is and how it is regulated, the present investigation seeks to adopt a critical approach against current AML/CFT regulations of the EU, highlighting its strengths and inadequacies. When needed, it will propose a solution to for the transformation of virtual currency into an AML-compliant electronic payment system.

1. Money Laundering, Methods and Schemes

The concept of Money Laundering refers, in general terms, to the process of cleaning the illegal earnings (dirty money) that are obtained from criminal activities such as corruption and bribery, drug-trafficking, extortion, human smuggling, illegal gambling, tax evasion, weapon smuggling and terrorism financing.

Money laundering is a complex process that can be carried out by using various methods, all containing three phases: placement phase where the illegally obtained money is placed in the legitimate financial system; layering phase to distance funds from its origin; and integration phase referring to the re-entry of the cleaned money to the mainstream economy.

There are various methods of money laundering within the phases mentioned above which are constantly evolving to circumvent the existential money laundering laws. While it is not easy to provide an exhaustive list, most common schemes include cash smuggling, offshore banking, global markets and underground banking (hwala). Schemes are only limited by the creativity of the criminals, and in time, more complex methods were introduced to circumvent the existing laws. Emergence of virtual currencies represents one of the challenges that Anti-money laundering laws are currently facing.

2. Virtual Currency

Virtual currencies should not be confused with electronic money or fiat currencies (dollar, euro, etc.). In contrast to fiat currency, virtual currency is a medium of exchange and/or a unit of account or store of value that does not

have a legal tender status[3]. While there is always a centralized authority that issues fiat currency, a central issuer is not always the case for virtual currency. The nature of it, on the other hand, is distinct from electronic money (e-money) which is a digital representation of fiat currency, being equal to an amount of fiat currency exchanged into electronic form by the central authority.

Virtual currencies can be divided into categories based on their use and their way of operation. Categorization based on their use is divided into 2 types, community related and universal virtual currencies. Community related virtual currencies are created specifically for a particular virtual world[4], where individuals can interact with each other, such as the World of Warcraft Gold, Microsoft Points or Amazon Coins. In other words, these currencies can only be spent in that particular virtual domain through the member's interaction with others. While some of these can be obtained with legal tender (Amazon coins and Microsoft Points), some can be obtained only by carrying out a particular task within these virtual worlds (WOW Gold). Yet, none can be converted back to a legal tender. Regarding the way of operation, all these non-convertible virtual currencies are centralized; they are issued and monitored by a central authority.

The use of universal currencies, however, is not limited to a specific computer-generated world but can be used to purchase real goods and services of the market. Not only can one obtain it with legal tender, but the user can also convert it back into a legal tender. Regarding the way of operation, universal currencies may be centralized (WebMoney) or decentralized (Bitcoin and Ethereum). Decentralized universal currencies are not issued by a central authority (put into circulation), and thus are not subjected to a central monitoring. These decentralized currencies are called crypto-currencies[5], transferred from one information system to another, for example, from computer to computer.

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[3] FINANCIAL ACTION TASK FORCE (FATF), *Virtual Currencies: Key Definitions and Potential AML/CFT* Risks, June 2014, available at *http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf.*

[4] Virtual worlds are computed generated environments for individuals to interact with each other who follow mutual interests.

[5] Cryptocurrency is a medium of exchange that uses cryptography to secure transactions rather than trusted third party.

i. *Bitcoin and the Blockchain Technology*

Bitcoin is the first decentralized convertible virtual currency, or cryptocurrency. Introduction of Bitcoin was done by Satoshi Nakamoto's self-published paper, «Bitcoin: A Peer-to-Peer Electronic Cash System»[6] in 2008, a response to the financial crises of 2008 that reduced individual confidence in financial institutions dramatically. The paper describes the need for an electronic payment system that would allow two parties to directly transmit value without a trusted third party for various reasons. It was first argued that the sector of commerce on the internet is growing and that financial institutions remain the sole, indispensable actors of e-commerce transactions. These actors of non-cash transactions (electronic transactions) are unable to avoid mediating disputes, leading to the rise of transaction costs, the limitation in the minimum amount to be transferred and the prevention of irreversible transactions for irreversible goods and services. To overcome the weaknesses of the system, it proposes a network that is not dependent on a trusted third party based on cryptographic proof[7] instead of trust[8]. Despite the invention of other cryptocurrencies since 2008, Bitcoin remained the most prominent one.

Bitcoin's market capacity, at the moment of the writing, 10th of March 2018, is approximately $160B (depending on the exchange rate of the day) with almost 17M Bitcoins in circulation. There is no central authority that puts Bitcoin into circulation. The network creates a Bitcoin every 10 minutes (on average) and guarantees that the supply of the Bitcoin never exceeds 21 Million (to be reached in 2140), where each unit can be broken into subunits. The system is secured by individuals called maintainers/miners. They try to verify transactions by solving highly sophisticated algorithms through their high-performance machines. The system adds the verified transaction to a transparent public ledger and rewards the maintainer/ miner with Bitcoin. Its exchange rate varies (due to user demand) which may differ $500 in a 12 hours period. Since

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[6] S. NAKAMOTO, «Bitcoin: A Peer-to-Peer Electronic Cash System», 2008, retrieved from *https://bitcoin.org/bitcoin.pdf.* (accessed on 05.06.2017).

[7] Cryptographic proof relies on private and public keys which are used in the process of transfer of value from a payer to a payee. These digital signatures ensure the security of the system.

[8] S. NAKAMOTO, «Bitcoin: A Peer-to-Peer Electronic Cash System», *cit.*, p. 1.

its invention, the exchange rate of Bitcoin reached a high of $20,052.60 in December 2017, with the rate of $9,423.00 at the moment of writing. The largest Bitcoin transaction so far was 194,933 Bitcoins, worth, at the moment of the transaction, $150M.

ii. *Acquiring Bitcoin*

Being a participant in the bitcoin network is easy and free. All a user has to do is download a virtual currency wallet[9] to a computer or smart phone or use an online version of a wallet (Coinbase, Bitcoin Wallet, Multibit). When it is downloaded, the account is created without needing an individual to disclose any information related to personal identification. Participant's identity is only linked to a Bitcoin address.

Acquiring bitcoin/cryptocurrency is no different than buying foreign currencies from exchange kiosks, banks or online banking systems. Unlike foreign currencies, for Bitcoin a merchant should go to a special exchange office, web platform or a bitcoin ATM that sells cryptocurrencies. Bitstamp for European (EUR) and Coinbase (coinbase.com), for USD based currency market, are the largest Bitcoin brokers where merchants can buy and sell cryptocurrencies. Depending on the national jurisdiction, cryptocurrency exchange offices are subjected to regulations as Know Your Client (KYC) and Customer Due Diligence (CDD) that has to be taken into account when buying. Depending on the requirements, obtaining bitcoins may take some time.

On the other hand, there are alternative ways to acquire bitcoin such as buying it from a local system participant or a friend directly in exchange with cash or a transfer of money. Furthermore, a merchant may sell a good or a service in its Brick and Mortar or online store for Bitcoin or altcoins[10]. Additionally, through a mining process, one may alternatively acquire Bitcoin.

[9] Virtual currency wallet is defined by FATF as means (software application or other mechanism/medium) for holding, storing and transferring bitcoin or other virtual currency. See FATF, *Virtual Currencies Key Definition and Potential AML/CFT Risks*, *cit.*, p. 7.

[10] A. M. ANTONOPOULOS, *Mastering Bitcoin*, O'Reilly Media, 1st ed., 2014, p. 10.

iii. *Vulnerability to Risks*

The use of virtual currencies has grown in numbers due to its easy, fast and cheap nature as compared to the traditional payment methods. Along with its benefits, the system is not invulnerable to risks related to the users, the market and the investors[11]. Risks related to the users are observed as losses incurred due to wallet theft, fraudulent exchanges and value fluctuations which were considered as the most probable scenarios to be realized[12]. On the other hand, investor concern is linked mainly to the volatility of the currency. Market concern, likely the most acknowledged one, is linked to risks of financial integrity including money laundering and terrorist financing, risk of financial crime such as trade of illegal commodities or ability to avoid seizure of assets and commodities, and tax evasion.[13] For the purpose of this paper, risks and regulatory measures other than money laundering and terrorist financing are not assessed further.

iv. *Virtual Currency in Money Laundering and Terrorist Financing Schemes*

Virtual currencies took their place in Money Laundering and Terrorist Financing Schemes and Methods next to the traditional tools such as offshore banking, alternative underground remittance services (hwala[14]) and international wire transfers.

a. Money Laundering

Benefitting from Virtual Currencies for money laundering purposes could occur in two different ways. First, dirty money obtained from illegal ac-

[11] N. VANDEZANDE, «Virtual currencies under EU anti-money laundering law», in *Computer Law & Security Review*, 33, KU Leuven Centre for IT & IP Law, 2017, p. 342, available online at *www.sciencedirect.com*.

[12] EUROPEAN BANKING AUTHORITY, *EBA Opinion on 'virtual currencies'*, 2014, pp. 21-22.

[13] *Idem*, pp. 33-35.

[14] Hwala is a method of transferring money without an actual movement, done through Hwala brokers. See Part I.

tivities as drug trafficking, human-trafficking or sale of various illicit commodities, could be exchanged through a virtual currency exchanger into a virtual currency (placement). Criminals could then use multiple transactions and purchases to obscure the origin of the obtained funds. Funds that are distanced from their origin could then be integrated into the mainstream economy (integration). In the second scenario, virtual currency obtained through criminal activity could be converted to a fiat currency and go through the same layering process to distance funds from their origin.

Silk Road is a commonly known name when it comes to the criminal usage of Bitcoin. Silk Road was an online market known for selling illegal commodities including drugs, armament, stolen credit card numbers, fake licenses and passports[15]. It provided its customers a monitoring-free and anonymous browsing by requiring payments to be made by Bitcoin and by limiting access to the website which could only be accessed through an anonymizing network, Tor[16]. From its creation in 2011 until its seizure in 2013, the website operated without legal enforcement due to its method of operation[17]. When the Federal Bureau of Investigation (FBI) shut down the website and convicted Ross Ulbricht, the founder of Silk Road, of money laundering, computer hacking and drug trafficking crimes, the reputation of virtual currency and Bitcoin being contributors of crime began to be acknowledged by the media and regulators.

b. Funding of Terrorism

Virtual currencies as a threat to counter terrorism efforts were dealt with different responses. While the National Terrorist Financing Risk Assessment of

[15] FBI, U.S. ATTORNEY'S OFFICE, «Manhattan U.S. Attorney Announces Seizure of Additional $28 Million Worth of Bitcoins Belonging to Ross William Ulbricht, Alleged Owner and Operator of "Silk Road" Website"», 2013, retrieved from *https://archives.fbi.gov/archives/newyork/press-releases/2013/manhattan-u.s.-attorney-announces-seizure-of-additional-28-million-worth-of-bitcoins-belonging-to-ross-william-ulbricht-alleged-owner-and-operator-of-silk-road-website* (accessed on 13.09.2017).

[16] The Onion Router (Tor) is an open and free software designed to conceal the real IP addresses of computers which prevents people from locating the users. See The Onion Router at *https://www.torproject.org/*.

[17] A. BRILL & L. KEENE, «Cryptocurrencies: The Next Generation of Terrorism Financing?», in *Defence Against Terrorism Review*, Vol. 6, No. 1, Spring&Fall 2014, p. 20.

the U.S. considers virtual currencies as a *potential* threat to financing of terrorism[18], the European Banking Authority considers Virtual Currency remittance systems as a high-risk development for the efforts against funding of terrorism[19].

According to the report of CNAS of 2017, virtual currencies recently became a threat to counter-terrorism measures due to its regulatory challenges[20]. They have not been used on a large scale yet, but authorities should not ignore the risks and should bring virtual currencies under law enforcement[21].

Unlike the money laundering cases, reports of terrorism funding by virtual currencies remains anecdotal[22]. There are reports from various intelligence services and governmental authorities containing information that terrorist groups in Gaza have been using Bitcoin to fund their activities, while some other reports claim that various Bitcoin wallets were found to be owned by Daesh militants. Recently, a Bitcoin and terrorism link was claimed by the Indonesian government in January 2017. Indonesian authorities declared that they have evidence on Daesh operatives using Bitcoin to transfer money to other operatives. One of the names that appeared in reports was Bahrun Naim, an Indonesian operative of the Islamic State, who is claiming to be the person behind the Jakarta attack of 2016[23]. Even though there is no official evidence proving that terrorists have been using virtual currencies to fund their activities, these incidents and intelligence reports proved, once again, the need to regulate virtual currency.

[18] DEPARTMENT OF THE TREASURY, WASHINGTON DC, «National Terrorist Financing Risk Assessment», 2015, retrieved from *https://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/National%20Terrorist%20Financing%20Risk%20Assessment%20%E2%80%93%2006-12-2015.pdf*. (accessed on 28.01.2018).

[19] EUROPEAN BANKING AUTHORITY, *EBA Opinion on 'virtual currencies'*, *cit*.

[20] These challenges are introduced under the topic "Characteristics related to AML/CFT Abuses" in this Part.

[21] CNAS, *Terrorist Use of Virtual Currencies, Containing the Potential Threat*, Energy, Economics & Security, 2017, p. 1.

[22] D. CARLISLE, «Virtual Currencies and Financial Crime, Challenges and Opportunities», in *Royal United Services Institute for Defence and Security Studies*, 2017, p. 18.

[23] COINDESK, P. RIZZO, «Indonesia's AML Watchdog Links Bitcoin to Islamic State», 2017, retrieved from *https://www.coindesk.com/indonesias-aml-agency-links-bitcoin-islamic-state-terrorism/* (accessed on 08.07.2017).

v. *Characteristics Attributable to AML/CFT Abuses*

a. Anonymity

The great deal of anonymity provided by the Bitcoin network to its users is one of the reasons that Bitcoin is linked to money laundering and terrorist financing, that criminals are encouraged to use it and that the media and regulators are giving a great deal of attention to it. Despite sales through anonymous digital wallets enabling launderers to conceal the origins of illegally obtained money and hardening the surveillance of the money flow, anonymity of bitcoin transactions is a widely misunderstood concept. To eliminate the misunderstanding, the paper compares two existing systems of transaction with the cryptocurrency transactions, PayPal[24] or traditional electronic transfers and payment with cash.

Because a mediating party is involved when some individual wishes to create a bank account she/he is subjected to disclosure of personal information that identifies the user. Therefore, whenever the account holder transfers money electronically to another account holder, identity of the payer and the payee appears in the system and the transaction is recorded in the ledger. Likewise, with PayPal, a user's account is attached to their bank account. Payments completed through PayPal are fully transparent as the financial institution monitors the flow of money between its two system participants. On the other hand, payments completed with cash are completely anonymous, whereby there is no institution (mediating party) to witness or supervise the transaction. Transactions through the Bitcoin network are different than the realities mentioned above and yet, also carries some of their characteristics.

As previously mentioned, a person is not required to disclose his/her identity or any other information when obtaining a bitcoin account, unlike creating a bank account through financial institutions. Hence, the system provides

[24] "PayPal is only a payment service provider whose main business is the issuance of E-money and the provision of services closely related to the issuance of e-money". See A. GUADAMUZ, «PayPal: The legal status of C2C payment systems», in *Computer Law & Security Report*, 2004, pp. 2-4, available online at *www.researchgate.net*. PayPal is covered under the scope of e-money directive 2009/110/EC.

privacy to its users. Thus, like in the transaction scenario of cash, identities of the payer and the payee are also anonymous in a bitcoin transaction.

Bitcoin differs from cash and appears to be more similar to traditional electronic transactions due to the transparency of bitcoin addresses. All transactions of a bitcoin address, from the first ever bitcoin transaction to the very last, are recorded in the public ledger. Hence, one can look to the public ledger (Blockchain) to see all transactions associated with the particular bitcoin address, the public key[25]. A publicly shared ledger makes these payments pseudo-anonymous rather than completely anonymous like cash payments.

However, upgrading personal security for the usage of cryptocurrency is possible through cryptocurrency mixing services/tumblers such as Helix, Bitcoin Blender and Ethereum Mixer. These services offer protection of privacy by mixing funds with others to hide where cryptocurrency came from originally and cleaning user's coin (layering phase). These systems function similarly to how one moves its funds through financial institutions located in countries that have strict bank secrecy laws such as Panama, Philippines, Cayman Islands and Curacao[26].

Thus, one can easily say that permitting some level of anonymity and the existence of cryptocurrency mixing services or tumblers to upgrade user anonymity makes cryptocurrency, namely bitcoin, highly desirable for money launderers, terrorists and others who carry out illegal schemes (criminal activities).

b. Easy, Cheap, Fast and Irrevocable International Transmissibility

Another reason that bitcoin is perceived as a potential money laundering and terrorist financing tool is linked with its cheap, quick and easy international transmissibility. A transaction can be sent from any place to anywhere, at any time and in any amount. For instance, a person located in Country A may initiate a transaction through an online exchanger located in Country B to acquire

[25] J. BRITO & A. CASTILLO, *Bitcoin: A Primer for Policymakers*, Mercatus Center, George Mason University, 2013, pp.8.

[26] UNITED STATES DEPARTMENT OF STATE BUREAU FOR INTERNATIONAL NARCOTICS AND LAW ENFORCEMENT AFFAIRS, *International Narcotics Control Strategy Report, Volume II, Money Laundering and Financial Crimes*, 2014, p. 36.

cryptocurrency with the national currency of Country C. Obtained cryptocurrency can be transmitted to a receiver located in Country D. The receiver may convert his/her cryptocurrency to the fiat currency of Country E, through an exchanger in Country F.

Additionally, while the costs of international transaction are much lower for peer-to-peer networks than fees required by trusted third parties (financial institutions), its transfer is completed within minutes rather than days. Moreover, surveillance of a transaction by financial institutions is not possible, so there is no authority to report and stop a suspicious transaction with abnormal money flow or to require a registration of cross-border transactions exceeding a certain value threshold. Cash transactions are also characterized as being irreversible. Once made, there is no way for it to be reversed by a financial institution or the user. However, the one factor that makes bitcoin an ideal payment method as opposed to cash is the complexity of carrying large amounts of cash around the world[27]. It is too weighty and burdensome to transfer large amounts of money without calling attention to authorities. Cryptocurrency, on the other hand, has no physical existence as a coin or a banknote. It faces no transfer obstacle.

c. Non-Centralized Institutions

Cryptocurrencies are popular due to their de-centralized nature. They are not backed by any public or private authority. Thus, there is no central institution for monitoring purposes. Traditionally, what hardens operations of money launderers, terrorists or persons who are involved in illegal activities, is the control mechanism carried out by the financial institutions through a system that allows transactions and group actions to be tracked. By carrying out due diligence, knowing your client mechanisms and reporting suspicious transactions, those institutions ensure the functionality of AML/CFT and mitigate the risks. Yet, in a peer-to-peer electronic transaction network, there is no central institution to ensure a functioning AML/CFT mechanism.

[27] M. MIMIC, *Regulatory challenges of alternative e-currency, comparative analysis of bitcoin model in US and EU jurisdictions*, Central European University, 2014, p. 27.

Up to a certain level, exchangers may operate as a control mechanism. They can subject their clients to CDD and minimize the anonymity of a user. Nonetheless, exchangers can never fully function as financial institutions since international transactions of cryptocurrency take place without any central channel, where the value is not transmitted through exchangers. In their case, observing a transaction, and not to mention reporting a suspicious transaction, will be impossible. Considering all the factors highlighted above, it is obvious to understand why criminals are attracted to this system.

Despite all the captivating features for money launderers and terrorist financers that are highlighted above, bitcoin has setbacks that limit its usefulness. These unattractive features are: unpredictable changes in the value of cryptocurrency, volatility of the currency, potential cryptocurrency wallet theft, failure to convert fiat currency to cryptocurrency or vice versa due to supply, demand and cost issues and rising regulatory awareness[28].

3. The Proposal to Amend 4th AML/CFT Directive

Identified risks related to the anonymity and decentralized nature of the virtual currency and its tendency to be used by criminals to conceal the source of the illegal gains raised concerns of regulators all over the world. Jurisdictions adopted different approaches to mitigate the risks related to the trade and usage of the decentralized virtual currency. The European Union followed an approach in which the issues related to virtual currency were treated at the theoretical level only, from 2012 to 2016 when the Commission presented a draft regulation amending the Fourth AML/CFT Directive in connection with the reveal of the Panama Papers and the terrorist attacks in Paris in 2015.

As a conclusion of the Justice and Home Affairs Council of November 2015, the Economic and Financial Affairs Council of December 2017, the European Council of December 2015 and as the part of the Action Plan to strengthen the fight against financing of terrorism, the Commission revised Anti-Money Laundering rules and proposed an amendment of the Directive (EU) 2015/849

[28] A. BRILL & L. KEENE, «Cryptocurrencies...», *cit.*, p. 15.

on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing and amending Directive 2009/101/EC on July 2016[29].

The revision was drafted in line with the recommendations of the European institutions such as EBA, ECB and ECOFIN Council, as well as the international policy guidance published by the Financial Action Task Force. It was drafted to form an international standard and to fill the gaps in existing regimes to tackle new challenges introduced by the advances in technology and communications that blur the transparency of financial transactions. The revision is in compliance with the principles of proportionality and subsidiarity regulated in Article 5 of the TFEU, the personal data protection laws of the EU; Directive (EU) 2016/680[30], Regulation (EU) 2016/679[31] and the Fundamental Rights, particularly the right to private and family life set out in Article 7, the protection of personal data set out in Article 8 and the freedom to conduct business.

Points that were amended in the proposal in regards to the virtual currencies are as follows:

Article 1(1) of the Proposal amends the Directive (EU) 2015/849 Article 2(1), regulating the obliged entities who are subjected to specific requirements under the Directive. The scope of the obliged entities who are natural or legal persons acting in the exercise of their professional activities (point 3 of Article 2(1)) was extended to include point (g) and (h) to cover exchange platforms of the virtual currency and the wallet providers offering custodial services. The matter is regulated as the following: "(g) providers engaged primarily and professionally in exchange services between virtual and fiat currencies; (h) wallet

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[29] EUROPEAN COMMISSION, «Proposal for a Directive of the European Parliament and of the Council amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing and amending Directive 2009/101/EC», 2016, p. 3.

[30] EUROPEAN UNION, «Directive (EU) 2016/680 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data by competent authorities for the purposes of the prevention, investigation, detection or prosecution of criminal offences or the execution of criminal penalties, and on the free movement of such data, and repealing Council Framework Decision 2008/977/JHA», 2016.

[31] EUROPEAN UNION, «Regulation (EU) 2016/679 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC», 2016, General Data Protection Regulation.

offering custodial services of credentials necessary to access virtual currencies"[32].

By the inclusion of the custodial wallet providers and the virtual currency exchange platforms to the obliged entities, the system participants who buy or sell their virtual currencies through these service providers are rendered to disclose their identity through Know Your Client and are subjected to due diligence measures regulated in Chapter II. The sale, purchase and usage of the virtual currencies can be monitored by the competent authorities, which would increase transparency in the transactions of virtual currency. Extending the scope of the Directive makes virtual currency exchange platforms and custodial service providers the gatekeepers of the anti-money laundering and counter financing of terrorism laws, as well as the authority who controls the access to virtual currency.

Another change to be brought to the Fourth AML Directive is in Article 3, which sets out the definitions to apply to the Directive. Point 18 is added to define virtual currencies with the purpose of reducing complexities in its definition and consequently adopting measures tailored for the characteristics of virtual currency.

According to Article 3(18) of the proposal "'virtual currencies' means a digital representation of value that is neither issued by a central bank of a public authority, nor necessarily attached to a fiat currency, but is accepted by natural or legal persons as a means of payment and can be transferred, stored or traded electronically"[33].

The proposed amendment to the Fourth AML Directive requires virtual currency exchange providers and custodian wallet providers to be licensed or registered, which is set out in Article 1, point 16 of the proposal. This is a complementary clause in achieving the control over exchange services providers and the custodian wallet services and ensuring that they will oblige with the requirements set out in the Directive. Additionally, registration of these platforms allows authorities to monitor transactions of virtual currency. Business licenses of virtual currency are regulated and issued by some jurisdictions al-

[32] Article 1(1).

[33] Article 1(2).

ready. One of the first licenses was granted by the New York State Department of Financial Services; it prohibits law platforms to operate without this license.

i. *Analysis of the Proposal*

It is possible to say that bringing virtual currency exchange platforms and the custodial wallet providers under the due diligence and Know Your Client requirements will contribute to the achievement of the objectives of this proposal, which are obtaining transparency in the transfer of funds, mitigating the anonymity of the system participants and monitoring the virtual currency transactions. However, one should approach the proposal more critically and assess whether it provides solutions to the risks brought by the specific characteristics of the cryptocurrency. The argument is set out below, where three characteristics of virtual currency, and more specifically cryptocurrency, will be assessed in the light of the proposal.

a. Anonymity

As mentioned in the previous Chapter, pseudo-anonymity is a major factor as to why criminals are attracted to cryptocurrencies. Non-disclosure of the identity works too well for criminals and eases their operation. Naturally, regulators had given full attention to tackle the anonymous nature of the cryptocurrencies. Subjecting virtual currency exchange providers and custodial wallet providers to CDD and KYC requirements will help to de-anonymize the users who are trading Bitcoin for a fiat currency (and vice versa) and whose wallets are under the custody of an agency (custodial wallet provider). Thus, if the proposal is adopted, whenever some individual wishes to obtain cryptocurrency through an exchange service platform, he/she will be subjected to some requirements pursuant of the Directive. These providers would know their clients through the information collected, and they will be able to observe the activities of their clients. The same will apply for the users who keep their cryptocurrency in a custodial wallet where the BTC, or any other cryptocurrency, is held by an

agency on the user's behalf[34]. Consequently, as the AML/CFT system requires, there will now be a trusted third party, an intermediary for a virtual currency transaction serving like an informant.

Throughout their operations, they will have to report suspicious transactions, any abnormal flow of funds, to the FIUs. However, the factors which render a transaction abnormal or suspicious are unclear.

Virtual currency is relatively a new phenomenon, and the transaction patterns are still unknown. Therefore, a comprehensive study should be carried out to understand what is considered as a normal transfer of fund and what is not to help exchange services and custodial wallet providers, who are mostly start-ups. The factor denoting suspicion could be based on geography. Jurisdictions considered as high-risk countries by law could be the focal point of the investigations. In other words, anytime a fund flows through a high-risk country, the system could alert the authorities and be subjected to a thorough investigation. Another factor could be determined by the threshold, in line with the profile of the client. If the client exceeds the threshold and cannot offer a rationale, these entities would report it to FIUs. If these remain imprecise, FIUs would be overwhelmed by the amount of the suspicious reports delivered by the exchangers and be left in a position where they cannot distinguish between false and true hits.

After the elaboration done above, it is not unusual to say, at this point, that the proposal would not fully achieve its objectives due to various factors. First, it fails to identify that the exchangers are not the only means for obtaining virtual currency. As mentioned in the previous chapter, users have other options for obtaining virtual currency in exchange of cash (from a local system participant or a friend) or through mining. These alternative ways are as easy as going to a Bitcoin ATM or to an exchanger. And it might be even simpler and faster if the proposal is to be adopted since no information needs to be disclosed. Within such an exchange, the third trusted party or the intermediary would not be present to function as a financial service, and the AML/CFT Directive will still be not applicable in those circumstances.

[34] COINSUTRA, «Bitcoin Wallter: Everything a Beginner Needs to know», 2017, retrieved from *https://coinsutra.com/bitcoin-wallet/* (accessed on 09.01.2018).

Another limitation of the amendment arises from the definition of the exchange services. The exchange services covered by the proposal are the "providers engaged primarily and professionally in exchange services between virtual currencies and fiat currencies"[35]. Obviously, this does not cover the exchange services between virtual currencies and other virtual currencies, such as Ethereum to Bitcoin and vice versa. Consequently, within this context, the new Directive will fall short in eliminating the anonymous nature of the virtual currency transactions

Wallets contain private keys[36] of the particular virtual currency address. The user may choose between "a wallet based on connectivity[37], the custodianship of keys[38] and wallets related to a specific device[39]"[40]. Custodial wallet providers, covered by the proposal, are the agencies who hold the private keys of the BTC address and exchange on behalf of the true owner of that currency. According to the proposal, these agencies will have to subject their customers to CDD requirements and be obliged to report to FIUs. Until this point, it seems that the virtual currency will be compatible with the AML/CFT laws, since a gatekeeper is restored within the system. However, one should not ignore wallets that are in the care of their true owners, the beneficial owners of the account. In those cases, a trusted third party is not present. Therefore, there are no trusted third parties to identify the user and to monitor, investigate and report the suspicious transactions. Because of this, the proposal will not sufficiently eliminate risks related to anonymity for the wallet users who take the responsibility of their own wallets.

It is highlighted above that the proposal will help to de-anonymize only the users who exchange their virtual currency with fiat currency and vice versa. While the accuracy and reliability of collected information might be disputed,

[35] Article 1 (1) of the Proposal.

[36] A. M. ANTONOPOULOS, *Mastering Bitcoin*, *cit.*, p. 84.

[37] Wallets based on connectivity are divided into two types, online and offline wallets.

[38] Custodial and non-custodial wallets depending on whether the user is responsible for its own funds or not.

[39] Device related wallets are the hardware wallets, mobile wallets, desktop wallets and the web wallets.

[40] COINSUTRA, «Bitcoin Wallter: Everything a Beginner Needs to know», *cit.*

the availability of the mixing services/tumbler should not be forgotten. These services offer protection of privacy by mixing funds with others to obscure the origin of funds and clean the coin of the user. Because of the availability of such methods, no matter how detailed, up to date, accurate and reliable the KYC documentation is, the user would still be able to circumvent CDD through these services.

On the other hand, as long as there are jurisdictions that do not regulate cryptocurrency and no limitation is put on the international transmissibility of the coin, criminals could simply acquire cryptocurrency against fiat currency, or the other way around, in other jurisdictions and use it within the EU to launder money or finance terrorism.

Last but not least, all the measures set forth by the AML/CFT laws regarding the virtual currency to de-anonymize cryptocurrency users would be inapplicable and obsolete if the usage of Bitcoin or any other cryptocurrency becomes widespread. In such a scenario, no one would feel the need to go to an exchange platform to acquire cash against virtual currency simply because they can buy and sell goods and services in exchange for a decentralized virtual currency. Under these circumstances, the money launderers and the financers of terrorism would be freed from going through KYC and CDD and have the ability to carry out their operations with ease. Naturally, this payment system would still be a threat for many jurisdictions that are incapable of inserting a trusted third party for virtual currency transactions.

b. Easy, Cheap, Fast and Irrevocable International Transmissibility

Another reason that Bitcoin is perceived as a potential tool for money laundering and financing terrorism is because of its comparative advantage against the traditional payment systems relating to its speed, the amount of transaction fees and the international transmissibility which is supported by the Bitcoin Protocol. While the proposal may seem to be incapable of having a direct effect on those characteristics[41], it is true that it actually may influence them.

[41] Unless the Bitcoin protocol is changed.

Virtual currency exchange platforms subjected to AML/CFT responsibilities, like financial institutions, will find themselves in a situation where the law compliance will be too burdensome due to the costs[42]. No one can be sure, but there is a great change for the costs of compliance and administration to affect the cryptocurrency transaction fees.

On the other hand, since the on-boarding of a client must be compatible with the law and all necessary documentation should be obtained from the customer, the speed of obtaining cryptocurrency and/or transferring would be affected. Consequently, the comparative advantage of cryptocurrencies would be gradually diminished, and some users would be discouraged by the rising costs and slowed and hardened transactions. However, these repercussions are still not enough for such currencies to disappear. As long as Bitcoin-like-coins are internationally transmissible and decentralized, there is no regulation that can stop users from benefitting from the exchange service platforms in other jurisdictions that operate without being obliged to comply with any regulation. Unless a protocol change is accomplished, those characteristics cannot be altered by anyone or any law.

As mentioned before, peer-to-peer transaction networks are similar to transactions held by cash, due to payments being irrevocable. In the case of wire transfers, funds flowing from or flowing to a suspicious entity would alert the financial institutions and may result in the confiscation of assets generated by criminal activities, which is an important tool for preventing and combatting crime as it deprives criminals of their profits. If the proceeds of crime are identified and traced in the traditional electronic transaction networks, pursuant to the Directive 2014/42/EU on the freezing and confiscation of instrumentalities and proceeds of crime in the European Union[43], member states are given rights

[42] Gathering information, record-keeping, risk assessment, suspicious activity reporting and etc.

[43] EUROPEAN UNION, «Directive 2014/42/EU of the European Parliament and of the Council of 3 April 2014 on the freezing and confiscation of instrumentalities and proceeds of crime in the European Union», 2014, retrieved from *http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0042#ntr4-L_2014127EN.01003901-E0004* (accessed on 23.01.2018).

and tools for the freezing and confiscation of the proceeds of crime[44]. However, transactions carried through decentralized peer-to-peer networks are irrevocable, and the nature of Bitcoin makes seizure difficult and problematic.

c. Non-centralized Institutions

Using consensus to regulate transaction and to prevent double-spending, the Bitcoin protocol and the Ethereum Protocol ensure the decentralization of the software[45]. If any individual or governmental body wishes to shut down the system and to freeze and confiscate the suspected funds, this is simply impossible since there is no centralized server[46].

In contemporary systems, money moves, and the transaction is concluded only if permission has been given by the financial institution. The system, in its nature, limits the individual by dictating it to have a bank account and to use a specific fiat currency if he/she wishes to participate in the financial system. On the other hand, peer-to-peer electronic transaction systems based on the Blockchain technology give society a chance to opt out of the utilization of a centralized service, which is why so many people are interested in this innovation and perceive it as the beginning of a new era for electronic transactions.

Whether or not the proposal introduces any measures to implement a central authority of control and management is a question that has already been answered above. In a Blockchain based system, a peer-to-peer transaction network, there is no central institution to ensure a functioning AML/CFT mechanism, no matter how stringent the obligations are for the intermediaries, if in-

[44] Currently there is a proposal for a Regulation of the European Parliament and of the Council on mutual recognition of freezing and confiscation orders. Available online at *http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52016PC0819*.

[45] A. E. GENCER, S. BASU, I. EYAL, R. VAN RENESE & E. G. SIRER, «Decentralization in Bitcoin and Ethereum Networks», 2018, p. 2, retrieved from *https://arxiv.org/pdf/1801.03998.pdf* (accessed on 01.02.28018).

[46] While decentralization is ensured by the system, it is true that the mining pools where the miners work cooperatively and share the reward, constitute a threat to the decentralization of the system. Especially due to the fact that the top 4 mining pools control more than %50 of the computing power of the whole system. See KASPERSKY, A. MALANOV, «Six Myths about blockchain and Bitcoin: Debunking the effectiveness of the technology», 2017, available online at *https://www.kaspersky.com/blog/bitcoin-blockchain-issues/18019/*.

termediaries exist. Therefore, no regulation would be sufficient to tackle such technical aspects unless a protocol change is accomplished.

Conclusion

Anti-money laundering laws emerged as a tool to cope with transnational narco-trafficking evolved throughout time due to social, economic and political concerns of the era, to respectively deal with organized crime and terrorism. Regulatory bodies, international and regional organizations, formed international standards to criminalize and prevent money laundering that undermines financial stability, regional and international economy as well as security. This paper addressed the need for a change in AML/CFT regulations to respond to technological developments undermining the current laws, facilitating criminals to conceal the origins of illegal gains and hide behind the emerging technology.

Revision of laws was proposed by acknowledging the distinct characteristics of virtual currency attributable to criminal activities such as decentralized nature, international transmissibility and pseudo-anonymity, as well as the technology behind virtual currency and its possible non-bitcoin applications that would benefit day-to-day activities of financial institutions and intellectual property rights.

To answer whether or not the current AML/CFT laws of the European Union adequately deal with virtual currency, this paper analysed the characteristics of cryptocurrency attributable to money laundering and terrorism financing offences. It also examined the Commission proposal, amending the Fourth AMLD in the light of those characteristics to answer the main research question "Is current AML/CFT Law of the European Union adequate in dealing with virtual currency?".

It was concluded that the proposal to amend Fourth AML Directive falls short of mitigating the AML/CFT risks posed by centralized, pseudo-anonymous nature of cryptocurrency, as well as its international transmissibility. It was argued that, even though the amending directive seeks to de-anonymize system participants, it does not introduce a sufficient and comprehensive mech-

anism, as it ignores alternative ways of acquiring cryptocurrency, the existence of mixing services, non-custodial wallet users and the possibility to spend cryptocurrency on real life purchases.

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Impact of Taxes on Competition – A Brief Summary

Francisco Andrade de Portugal *

1. Introduction

The main purpose of this paper is to present the main conclusions achieved by the author in the article "Impact of Taxes on Competition – the Legal Status Quo in the European Union".

The academic study underlying this paper is aimed at demonstrating that taxes have a significant impact on competition. Further, the study is aimed at demonstrating that taxes not only have a negative impact on competition but that they can also have a positive impact.

Taxes may interfere with the normal balance of the market. Transfers of financial resources from market actors to the State (and vice versa) always open doors for distortions of competition. Thus, taxes affect the natural allocation of financial resources, and they may affect it inappropriately.

However, according to the author, one cannot restrict the effects of taxes to their negative side. Despite the obstacles that taxes often present to competition, taxes should also be regarded as an ally, to the extent that they can foster competition and be used to protect the interest of all market participants and correct serious market failures. For instance, governments can make use of the tax system to foster competition in monopolistic markets.

As the OECD notes, "[t]he actual impact of [tax] state aids and subsidies is difficult to assess. On the one hand, they may cause distortions and inefficiencies. On the other hand, they are frequently rationalised as an instrument to tackle market failures and to produce positive externalities"[1].

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* LL.M. in European and Transglobal Business Law.

[1] OECD, «Competition, State Aid, and Subsidies», in *Competition Policy Roundtables*, 2010, p. 1.

Therefore, the negative and the positive effects that taxes have on competition may be regarded as two sides of the same coin. In some cases, taxes are a foe of competition, while in other cases, they act as a true ally.

The assessment of whether the impact of taxes on competition is positive or negative depends on the delimitation of the main purposes of competition law. If we consider the protection of the free market to be the main goal of competition law, we will easily find situations where taxes have a negative impact on competition. On the other hand, if we consider that the ultimate purpose of competition law is to protect all market participants (producers, distributers, sellers, consumers and ultimately, society) and that the protection of the free market is just a means of achieving a superior end, (societal welfare) taxes will more often be considered an ally of competition. The author tends towards the latter approach.

The study that underlies this paper was limited to the European context. The legal framework of taxes and competition in the European Union provides an excellent theoretical basis to launch a pertinent debate. Therefore, we will find very limited references to the international context in this paper. In the upcoming sections, we will discuss the negative and the positive impact of taxes on competition. Then, we will present the main conclusions and some recommendations.

2. Taxes as a Foe of Competition

2.1. *General Context*

Economic theory upholds that competition is extremely important to improve the welfare of European citizens. Increased competition can lead to higher efficiency, innovation, and cheaper and better products. Consequently, the competitive process should remain undistorted, unless there is a valid reason of public interest justifying the distortion.

As taxation interferes with the natural allocation of financial resources, it might distort competition. For instance, when governments make use of the tax system to benefit certain firms, sectors, or regions without the public interest in

mind, they may affect the level of the playing field. In the present part of this paper, we will illustrate the negative impact that taxes may imply for competition.

2.2. *Custom Duties*

Custom duties or tariffs are a basic example of the serious impact that taxation may present for competition and trade.

Custom duties are taxes levied on goods imported into one country by the custom authorities. These taxes can be imposed on a specific basis, on an *ad valorem* basis or as a combination of both[2], having dual functionality. On the one hand, they serve to raise revenues for the State. On the other hand, and most importantly for the purpose of this article, custom duties often serve to protect specific domestic industries from foreign competitors[3]. Custom duties increase the price of imported goods, discouraging their purchase and giving an advantage to locally-produced goods.

Thus, custom duties are tools that allow governments to protect their economy, safeguarding national companies from foreign competitors. Nonetheless, the control of such imported goods constitutes a serious restriction of free competition. Custom duties interfere with the normal balance of the market and can prevent economies of scale. By discriminating against domestic and foreign goods, governments ease the production of national products, thereby reducing competition. As previously mentioned, less competition theoretically results in less innovation as well as more expensive and lower-quality products. Therefore, custom duties might be a serious foe of competition.

2.3. *Tax Aids*

Governments often intervene in the economy by granting financial aids to certain sectors or specific companies with the purpose of solving market fail-

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[2] ANDREW GUZMAN & JOOST PAUWELYN, *International Trade Law*, 2nd ed., Wolters Kluwer Law & Business, 2012, p. 167.

[3] IBFD, *International Tax Glossary*, 6th ed., Julie Rogers-Glabush, 2015, p. 109.

ures. This government intervention in the economy presents a problem; either by lack of budgetary discipline, powerful lobbies or corruption, occasionally, governments do not perform such tasks efficiently from a public interest perspective[4]. Sometimes governments grant public money to companies through the tax system (tax exemptions, tax allowances, tax deferrals...) that do not pursue activities of public interest or, even if these companies do pursue activities of public interest, the funds are granted selectively instead of being attributed generally. Selective tax advantages should be avoided whenever possible to prevent distorting the level playing field.

Similar to the way in which custom duties affect competition and international trade, the same can be said about tax aids granted to the production of certain products. For instance, if one government grants a selective tax advantage to one of its major national companies with the aim of stimulating the export of national products, it may distort competition and international trade. This measure allows the company to sell its products at lower prices and to place itself in a situation of comparative advantage over its competitors (either national or foreigner), thereby distorting competition. Subsidies or state aids, and particularly tax aids, may create severe distortions of competition.

A tax aid is characterized as a transfer of state resources by public authorities, even if indirectly, in the form of foregone revenue for the State. Moreover, a tax aid implicates the selective grant of an economic advantage to an undertaking, and it is a measure which distorts, or has the potential to distort, competition and trade between Member States.

Provided it is made in selective terms, the adoption of any of the following measures may constitute distortive tax aid: granting a reduction of the tax base (through tax allowances or extraordinary amortizations), a reduction of the amount of tax due (through tax exemptions or tax credits), tax deferrals or even exceptional rescheduling of the tax debt[5].

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[4] CHRISTIAN BUELENS, GAËLLE GARNIER, RODERICK MEIKLEJOHN & MATTHEW JOHNSON, «The economic analysis of state aid: Some open questions», in *Economic Papers*, 2007, p. 8.

[5] RODRIGO MAITO DA SILVEIRA, *Tributação e Concorrência*, Instituto Brasileiro de Direito Tributário, Quartier Latin, 2011, pp. 219 *et seq*.

Thus, tax aids may severely affect competition. For that reason, tax aids are, in principle, forbidden by the GATT[6] as well as by EU state aid control.

2.4. *The Lack of Tax Coordination*

The lack of tax coordination in the EU and the consequent existence of 28 different tax systems in the internal market also creates significant obstacles to competition at various levels.

To begin with, European firms compete with each other under different rules. These different rules involve the application of different tax rates and also different administrative procedures.

As Terra and Wattel unreservedly assert, "[d]ifferences between Member States' domestic laws and administrative practices may cause serious distortions to the conditions of competition within the internal market"[7].

A company located in one Member State that is allowed to satisfy one specific tax obligation in one year is certainly better off than a company located in a different Member State obliged to fulfil its tax obligation in one month. During that one-year period, the first company has at its disposal financial resources that may result in a better performance in the market, whereas its competitor has to deliver those financial resources to the State coffers by the end of the one-month period. Thus, not only different tax rates applicable across the EU, but different administrative procedures and accounting rules also affect the level playing field in the internal market.

Secondly, the discrepancy of tax rules within the internal market has the additional disadvantage of harming European companies that exercise economic activities across the internal market. Companies exercising activities throughout the internal market must be aware of the tax rules applicable in all jurisdictions where they perform economic activity, and they must deal with the tax administration of each Member State. Thus, a company with economic presence in all Member States must also be aware of the specificities of each of the 28 tax systems in the European Union to satisfy its tax obligations. Furthermore, it also

[6] Article 1 of the Agreement on Subsidies and Countervailing Measures.

[7] BEN TERRA & PETER WATTEL, *European Tax Law*, 4th ed., Kluwer, 2005, p. 21.

needs to deal with 28 different tax administrations. This involves high compliance costs and heavy administrative burdens for such companies[8]. Consequently, the lack of tax coordination makes EU-based companies less efficient and less competitive.

European firms have to face extra difficulties when compared to their American, Japanese or Chinese competitors, who only have to deal with one tax system and one tax administration, despite exercising economic activities throughout their whole respective territory[9]. Foreign counterparts can be more competitive and perform better in the worldwide economy because they have less compliance costs and less administrative burdens. In the long run, the European economy is not able to accompany the growth of its rival economies, which poses negative consequences for European citizens.

Hence, the lack of tax coordination in the internal market presents a strong obstacle to competition. On one hand, it results in unfair competition within the internal market because it makes European firms compete with each other under different tax rules, affecting the level playing field. On the other hand, the lack of tax coordination makes companies exercising economic activities throughout the internal market less competitive when compared to their foreign competitors due to the high compliance costs which they must follow to fulfil their tax obligations in each Member State. European companies being less competitive truly diverges from the main objectives of EU competition policy.

2.5. *Base Erosion Profit Shifting and Tax Aid Cases*

The European Commission is currently scrutinising some cases that can be good examples of how certain tax measures can conflict with the competition policy purposes. These cases involve the erosion of tax bases, shifting of income and tax aids.

[8] See CHRISTOPH SPENGEL & CARSTEN WENDT, «A Common Consolidated Corporate Tax Base for Multinational Companies in the European Union: some issues and options», in *Oxford University Centre for Business Taxation Working Paper 17*, 2007, p. 8.

[9] EUROPEAN COMMISSION, Memo/11/171, Questions and Answers on the CCCTB, 2011, p. 6.

For years, several multinational companies have developed complex tax planning, involving the creation of holding companies and subsidiaries in the European Union[10], to minimise their tax obligations and consequently obtain a comparative advantage over their competitors. Global operations have been used by a vast number of multinational companies as a means for substantially reducing their tax obligations, increasing their profits and acquiring an advantage over their competitors[11].

Several multinational companies have established their international headquarters in Member States of the EU that confer a much more favourable corporate income tax when compared to their original country. The 12.5% corporate income tax applied in Ireland, for instance, is much more attractive than the 35% corporate income tax rate applied in the US[12].

Additionally, these multinational companies earn profits in several countries and then transfer the revenues to their headquarters, which are based in low-tax jurisdictions such as Ireland, Luxembourg and Netherlands. Thus, the profits made by these multinational companies are only taxed (at low tax rates) in the Member States where such companies established their headquarters.

These multinational companies take advantage of the existing loopholes of bilateral tax treaties to shift their profits to low tax jurisdictions, which results in "double non-taxation" or "less than single taxation"[13].

While such aggressive tax planning can be disapproved from a moral point of view, it is important to note that it is not illegal under the current legal framework, as long as the companies established in the EU actually perform genuine economic activities in the jurisdiction where their headquarters are es-

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[10] See SABINA ÖRBERG, *Tax Planning with Holding Companies for US Investors in Europe – A Comparative Study of Holding Regimes in Sweden and Switzerland*, Lund University, 2013, pp. 5 *et seq.*

[11] BMR ADVISORS, «Base Erosion and Profit Shifting ("BEPS") – Intangibles», Vol. 1, No. 9.2., 2013.

[12] See SABINA ÖRBERG, *Tax Planning with Holding Companies for US Investors in Europe…*, *cit.*, p. 5.

[13] OECD, «Action Plan on Base Erosion and Profit Shifting», 2013, p. 10, available at *http://www.oecd.org/ctp/BEPSActionPlan.pdf*.

tablished[14]. Hence, these multinational companies usually perform small activities of their businesses in low-tax jurisdictions, arguing that they are performing genuine economic activity there and should therefore, be taxed according to the tax system of such jurisdiction.

The aggressive tax planning practiced by several multinational companies does not only involve the shifting of income and the erosion of tax bases but also tax agreements with Member States where they have established their headquarters. It is here where the "tax optimisation" practiced by several multinational companies may have become illegal, as such individual negotiation of the applicable taxes with the competent authorities may constitute prohibited tax aid in the meaning of Article 107(1) of the TFEU.

The European Commission is investigating the transfer pricing agreements, also known as advanced pricing agreements, established between Member States and multinational companies, which are liable to confer a selective economic advantage over the latter. The advanced pricing agreements allegedly celebrated between the multinational companies and the EU Member States establish the application of a more favourable set of criteria for the determination of the prices of intra-group commercial transactions[15]. These transfer pricing agreements involve the low or non-taxation of royalties, intellectual property rights, and loan interests. Such agreements confer a selective economic advantage to these companies as the prices established for these intra-group transactions will automatically be accepted by the tax authority of the country adopting the transfer pricing agreement[16]. The taxes paid by such companies are thus much lower than they would be under normal conditions; this in fact places them in a better position when compared to their competitors who lawfully fulfil their tax obligations, altering the level playing field.

[14] See SABINA ÖRBERG, *Tax Planning with Holding Companies for US Investors in Europe…*, *cit.*, p. 6. For further developments see also RAFFAELE RUSSO, *Fundamentals of International Tax Planning*, 2007, pp. 55 *et seq.*

[15] See COVINGTON & BURLING LLP, *European State Aid and Investigations into Tax Rulings*, 2014, pp. 1 *et seq.*

[16] *Ibid*.

3. Taxes as an Ally of Competition

3.1. *General Context*

After having briefly demonstrated that taxes can have a negative impact on competition, we will now focus on their positive impact. Although the positive impact that taxes have on competition is not as palpable as their negative impact, the tax system is a valuable tool that governments have at their disposal to satisfy the main purposes of competition policy – in particular, fostering competition, ensuring the maintenance of the level playing field, correcting market failures and protecting all market participants. The positive value that taxes can have from a competition policy perspective must not be overlooked, as we will demonstrate in this part of the text.

3.2. *Custom Duties*

As previously discussed, custom duties are a tool that allows governments to control the flow of goods. While it is true that the massive imposition of custom duties on imported goods affects competition and international trade, it is also true that a precise imposition of custom duties may have a positive impact from an EU competition policy perspective. Namely, charging custom duties on goods produced in countries that practice social dumping[17] is a measure that can help make competition fairer. Even though this measure affects international trade, it actually contributes to balanced competition in the internal market.

Since the European Union is based on a social model, it has high standards concerning workers' protection, such as minimum wages and limits of weekly working hours[18]. For that reason, it may be difficult for European firms to compete with foreign players who do not adhere to such standards and aim

[17] Social dumping can be defined as "the practice, undertaken by self-interested market participants, of undermining or evading existing social regulations with the aim of gaining a competitive advantage". See MAGDALENA BERNACIAK, «Social Dumping and the EU integration process», Working Paper 2014.06, European Trade Union Institute, 2014.

[18] As a result of the imposition made by Article 153 of the TFEU.

to sell their products in the internal market. Those external companies do not guarantee adequate conditions to their workers, so they have lower production costs and can exercise extremely low prices. From these examples, it can be shown that social dumping results in unfair competition.

It is true that European firms would be protected from foreign competitors if custom duties were applied to products imported from such countries. However, it would be legitimate to do so because where European firms must support the normal costs of granting adequate treatment to their workers, their external competitors operate under different rules which allow them to reduce their production costs by treating their workers poorly. This competitive advantage is unfair from a European perspective, and it would be sensible to impose custom duties on goods produced in those foreign countries.

It would not be fair, or reasonable, for European firms to be obliged to respect high standards of workers' protection (which would be maintained to ensure social welfare) and simultaneously make them compete with foreign companies that have very low production costs due to social dumping. Thus, custom duties can make competition fairer.

3.3. *Transfer Pricing*

The transfer pricing rules currently in force present another situation where the tax system acts as an ally of competition. Even though this system implies extra administrative costs for EU-based companies (due to the documentary proof that it requires), in truth, it is designed to make competition fairer.

Transfer pricing refers to the terms and conditions surrounding transactions within a multinational company. It concerns the prices charged to associated enterprises established in different countries for their intra-group transactions[19]. As previously mentioned, multinational companies have been adopting business strategies that involve the creation of subsidiaries and branches

[19] *http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/index_en.htm.*

throughout different countries. As a rule, each affiliated company would be taxed separately by the country in which it operates[20].

However, companies frequently use transfer prices as an allocation method. Since transfer prices are set by non-independent associates within the company, multinational entities may set transfer prices on cross-border transactions to reduce taxable profits in their jurisdiction[21]. As the main purpose of companies is to maximise their overall profits, they frequently try to allocate their profits through transfer prices to low tax jurisdictions with the purpose of reducing their tax obligations. Hence, the transfer pricing mechanism is a tool that corporations use to avoid high taxation in certain jurisdictions[22].

The transfer pricing rules currently in place aim to prevent companies from unlawfully reducing their tax obligations and obtaining a comparative advantage over their competitors who rightfully fulfil their tax obligations.

Under the present transfer pricing system, intra-group transfers of values have to be priced in the same manner as independent companies in the market, using an arm's length principle[23]. Rules and procedures applicable to transfer pricing are usually found in the domestic law of many countries[24]. By setting the prices to be applied to intra-group transfers and making affiliated enterprises treat themselves as independent entities, tax administrations prevent companies from allocating their profits to low tax jurisdictions. In other words, transfer pricing rules ensure that all market actors pay the taxes they owe and prevent companies from artificially shifting their profits to low tax jurisdictions, thereby ensuring fair competition.

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[20] MARIA JOÃO MAURÍCIO, *Transfer Pricing and the arm's length principle in the European Union law and domestic law*, Escola de Direito da Universidade do Minho, 2013, p. 1.

[21] *http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/index_en.htm.*

[22] MARIA JOÃO MAURÍCIO, *Transfer Pricing and the arm's length principle..., cit.*, p. 2.

[23] This arm's length principle is found in article 9 of the OECD Model Tax Convention: "[When] conditions are made or imposed between [...] two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".

[24] In many cases these reflect the *OECD Transfer Pricing Guidelines*, IBFD, 2015, pp. 449.

Thus, we can consider the transfer pricing system to be an ally of competition, even though it involves extra compliance costs both for EU-based firms and tax administrations.

3.4. *Environmental Taxes*

Likewise, environmental taxes present another situation where taxes can act as an ally of competition. Environmental taxes can promote fair competition in the internal market by eliminating the comparative advantage that certain external competitors have when compared with European firms for not having to respect the minimum standards of environmental protection established in EU law.

Environmental protection is currently one of the most pressing concerns of the European Union. The Treaty on the European Union establishes that Member States shall promote a sustainable use of the environment[25]. Consequently, EU-based firms must respect high standards of environmental protection, which naturally increase their production costs.

Because certain foreign companies who sell their products in the internal market do not have to fulfil the same environmental standards, this makes competition in the internal market unfair. As those companies do not have to obey the same standards, they have lower production costs, which gives them a comparative advantage. Therefore, environmental dumping results in unfair competition.

Just like custom duties, environmental taxes can be used to ensure that European firms are not harmed by foreign competitors that practice environmental dumping. In this case, there is a valid reason to protect European firms.

It would not be reasonable to make European firms respect high environmental standards and simultaneously make them compete directly with companies that are able to produce extremely cheap products due to environmental dumping. For that reason, there is no doubt that environmental taxes

[25] Article 3.3 of the TEU.

can be a true ally of competition, ensuring the maintenance of a level playing field.

4. Conclusions and Recommendations

4.1. *General Context*

The analysis made so far shows that taxes have a significant impact on competition. In some situations, they have a negative impact by creating obstacles and restricting free competition. In other situations, taxes act as a true ally by correcting some market failures and levelling the playing field.

Thus, it is crucial from a competition policy perspective to correct the situations where taxes constitute an obstacle and reinforce the situations where taxes have a positive impact. Accordingly, some recommendations will now be provided with that goal in mind.

4.2. *Recommendations*

The recommendations that follow are meant to be a set of guidelines that could inspire European policymakers. This proposal is not exhaustive and is open to additional developments. The purpose of these recommendations is to provide some orientations that the author believes could contribute to challenging the legal *status quo.*

1. First and foremost, an indispensable measure would be the creation of a group of experts specifically responsible for finding solutions to reduce the obstacles that taxes create for competition and to foster their positive effects. Previous experiences show that the creation of a group of experts in charge of the discussion of specific matters can be a truly proficient mechanism that leads to important results. This was the case of the Primarolo Group[26], the group of experts formed in 1998 to ensure the administration of the Code of Conduct for

[26] The Group was named after Mrs Dawn Primarolo, the UK Paymaster General, who chaired the group.

Business Taxation. This was the first time that tax policy makers of the EU Member States reached a proper agreement on corporate taxation[27].

2. The harmonisation of applicable tax rates in the internal market is another measure that would constitute a major step toward balancing competition in the internal market. However, there is still resistance from EU Member States to take that step. Thus, with the impossibility of fully harmonising applicable tax rates in the internal market, EU Member States should be able to define the minimum and maximum corporate income tax rates applicable in the internal market, similarly to what it set out in the VAT directives. Today, there is a massive gap between corporate income tax rates in the internal market, varying between 12.5% (applied in Ireland) and 33% (applied in Belgium and France); Member States should reach an agreement to reduce this gap and make the competitive conditions in the internal market more equitable. This would not fully take fiscal sovereignty away from Member States, but it would reduce the gap and disparity of tax treatments granted throughout the internal market. Further, if such an agreement could be reached, Member States could additionally establish how this gap can be progressively reduced over time until corporate income tax rates become fully harmonised.

3. Even with full harmonisation of applicable tax, it would still be necessary to coordinate the administrative and accounting rules in the internal market. For that reason, it is vital to adopt a single set of tax rules applicable throughout the internal market, and here the Common Consolidated Corporate Tax Base (CCCTB) proposal can prove to be very useful. The CCCTB is a proposal which asserts the creation of a single set of tax rules applicable throughout the entire internal market. This single set of tax rules can even be condensed into a tax code that coexists with the tax laws of each of the Member States[28].

[27] See CLAUDIO M. RADAELLI, «The Code of Conduct Against Harmful Tax Competition: Open Method of Coordination in Disguise?», in *Public Administration*, Vol. 81, No. 3, 2013, pp. 521 *et seq*.

[28] See JOÃO SÉRGIO RIBEIRO, «Tributação das Sociedades de Acordo com uma Base Comum Consolidada na União Europeia», in *Estudos em Homenagem ao Professor Doutor Alberto Xavier*, 2012, p. 732.

Thus, the scope of the CCCTB proposal is independent from the harmonisation of tax rates. It relates only to administrative and accounting rules.

The CCCTB proposal would facilitate the exercise of economic activities in the internal market and, consequently, increase competition. Under the CCCTB, European firms exercising economic activities throughout the internal market would only have to deal with a single set of tax rules and a single tax administration. As a result, European firms, particularly SMEs[29], would find it easier to expand their business to other Member States, increasing competition in the internal market[30]. Therefore, the adoption of a CCCTB could certainly contribute to a change in the legal *status quo* and remove some of the obstacles that tax systems imply for competition.

4. In the field of indirect taxation, even though the European Union already forbids the imposition of custom duties on imported products, it would be important to strengthen these rules in such a way that Member States could not resort to artificial schemes to impose disguised custom duties (like the re-registration process of cars) and affect competition in the internal market[31]. It is fundamental to ensure that the only custom duties or charges having an equivalent effect charged in the internal market are the ones imposed on goods coming from external countries that practice social and environmental dumping.

5. The New Horizontal Directive[32], which is supposed to coordinate the application of excise duties in the internal market, should be made more stringent. This Directive does not impose the maximum tax rates applicable. By not

[29] The European Commission expects that SMEs of a medium sized enterprise expanding within the EU could be reduced by 67% with the CCCTB proposal. See EUROPEAN COMMISSION, Memo/11/171, «Questions and Answers on the CCCTB», Brussels, 2011, p. 5, available at *http://europa.eu/rapid/press-release_MEMO-11-171_en.htm?locale=en*.

[30] A third advantage that the CCCTB would bring is that it would make tax competition between Member States much more transparent. As the factors that constitute the tax base would be standardised it would be enough to look at the different rates. For further developments see JOÃO SÉRGIO RIBEIRO, «Tributação das Sociedades ...», *cit.*, p. 733.

[31] MARIO MONTI, *A New Strategy for the Single Market*, Report to the President of the European Commission, 2010, p. 40.

[32] Council Directive 2008/118/EC of 16 December 2008.

doing so, the New Horizontal Directive allows distortions of competition to continue, as is the case of excise duties on gasoline. Thus, the author proposes that the New Horizontal Directive should be revised, setting the maximum tax rates of excise duties applicable in the internal market.

6. On the topic of tax aids, some soft law instruments used by the European Commission to assess the legality of the tax aids granted by the EU Member States should be converted into hard law instruments, especially the 1998 Commission Notice on fiscal state aid. Such conversion would increase legal certainty, giving Member States the possibility to be sure that the tax aids they intend to grant are in line with competition policy aims, avoiding situations where they grant illegal tax aids.

Furthermore, European institutions should increase the Member States' responsibility in the granting of tax aids. Heavily fining Member States that grant illegal tax aids would possibly reduce the number of situations where Member States unjustifiably grant tax aids that distort competition.

The creation of a sub-division inside the European Commission, or even of an autonomous body with the sole responsibility of controlling tax aids, is another measure that can make tax aid control more efficient and reduce the resulting distortions of competition. A body specifically focused on controlling tax aids would certainly be more efficient than a supranational authority that is responsible for controlling all types of state aid. As we have seen, the concept of state aid is so broad that it is very difficult for a single institution to effectively control the grant of all types of state aids.

Additionally, giving more power to national competition authorities to control tax aids could help avoid situations where Member States distort competition through the tax system. National competition authorities are more aware of any changes in their national tax system than the European Commission. Thus, national competition authorities can be extremely useful in making tax aid control more efficient. Accordingly, they should receive more power to collaborate with the European Commission in controlling tax aid.

7. Last but not least, EU policymakers should agree on the substitution of the unanimity rule by a qualified majority voting. The unanimity rule fosters an internal market that is highly underdeveloped in regards to tax matters. A qualified majority voting would simplify the legislative procedure on tax matters and allow for the shift that the current legal framework so urgently needs. EU Member States should not be reluctant on adopting this measure as a qualified majority voting does not entail the harmonization of taxation in the European Union. It simply eliminates the "hidden veto" that each Member State has under the unanimity rule[33].

To conclude, the adoption of these measures is crucial to correct the obstacles that taxes frequently constitute for competition. Some of these recommendations might be broad in scope and be too ambitious, but they simply aim to provide some fundamental orientations that could guide EU policymakers. It is the author's belief that the adoption of the majority of these recommendations is in the future of European law.

4.3. *Final Conclusions*

The main conclusion of this essay is evidently that taxes can be a foe as well as an ally to competition. On one hand, we have shown that taxes can be responsible for making competition unfair and making European companies less competitive and less efficient. On the other hand, we have verified that tax systems can perform a key role in the achievement of some of the most important goals of competition policy namely, fostering competition, ensuring the maintenance of the level playing field and protecting all market participants. The negative and the positive impact that taxes have on competition shall be regarded as two sides of the same coin.

Although taxes may be an ally of competition, our analysis shows that the negative impact of taxes on competition is more perceptible than their positive impact. Thus, it is vital from a competition policy perspective to challenge the legal status quo, by correcting the situations where taxes constitute an ob-

[33] PATRICIA LAMPREAVE, «Fiscal Competitiveness versus Harmful Tax Competition in the European Union», in IBFD, *Bulletin for International Taxation*, Vol. 65, No. 6, 2011.

stacle to competition and by fostering their positive impact. There are measures that European policymakers could adopt to reduce the negative impact of taxes on competition. However, the adoption of such measures requires a strong political commitment from all EU Member States. But if Member States are willing to adopt those measures, the obstacles that taxes bring for competition will surely be reduced, making competition in the internal market fairer, European firms more competitive, the European economy more prosperous and welfare for European citizens better, which is the ultimate goal of EU competition law.

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Outsourcing Contract: A Legal Perspective

Isabel Fidalgo da Silva *

1. Introduction

At the present moment, companies' traditional strategies are suffering changes, mostly due to market competition. Firms are rethinking their strategic and operational organization[1].

Due to this competitiveness, companies transfer their processes or activities to external third parties, outsourcing companies, on a daily basis to minimize costs, but primarily, are able to achieve the added value of being focused on their core activities. This thesis shows the myriad of legal risks that are associated with the business process of outsourcing, especially when it involves different jurisdictions. The concept of outsourcing is not a novelty, due its origin, which lies in the subcontract concept. Nevertheless, the former is characterised by a more evolving contractual long-term relationship. This research focuses on the structure, which is currently developed by the parties, regarding its content and relationship. This transfer of activities or services for an external party has no standard form to be handled, and the doubt remains between the necessity of negotiation, eventual framework and a better contractual governance.

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* Trainee-Lawyer at N-Advogados, Nuno Albuquerque, Deolinda Ribas, Sociedade de Advogados, R. L., Braga, Portugal.

Master's LL.M. in European and Transglobal Business Law at the University of Minho – Law School, Braga, Dissertation concluded, *Outsourcing Contract: A Legal Perspective* (2016).

Post-Graduation in Fashion Law at Faculty of Law of the Portuguese Catholic University, Final Essay concluded with the support of *Fashion Industry and Sourcing in Europe: Outsourcing and Subcontract Legal Perspective* (2018).

For further understanding of this article's topic it is suggested to consult the above mentioned Master's Dissertation.

[1] M. M. LEITÃO MARQUES, «A Empresa, o Espaço e o Direito», in *Revista Crítica de Ciências Sociais*, 22, 1987, p. 70.

Despite the associated risks, it is usual for parties to enter into an outsourcing contract and inherent service-level agreement. However, not all the complexities are taken into account. These might translate into attrition, opportunistic behaviour, or even termination of the relationship. The reasons for relationship failure are numerous, but, these obstacles have been overcome by the establishment of contracts between the parties, although some national laws regarding certain specific legal matters, substantially impact the contract and the agreement will also be applicable.

The outsourcing contract is considered a mixed contract with specific contours. Although these business transactions are constantly negotiated, no standard form exists, and international efforts to harmonise guidelines have been few. The most complex or sensitive transactions often involve IT, intellectual property rights, data transfer and financial services. Although the European Union has already enacted directives concerning these matters, there are additional issues that need to be developed and discussed. This has already been subject to discussion occasionally in the literature, yet the positions may not be the same. This work provides insight into the outsourcing contract, which entails a certain complexity and requires wise handling. Therefore, it becomes relevant to also understand the concept of outsourcing, the stages of the process and associated legal risks, common issues that arise during the contractual relation, the exposure to the national laws of the contracted party, as well as the question of how this relation is sustained by a maturity process carried out by the parties, although eventual legal pitfalls may exist.

Moreover, a substantial part of the academic literature mainly approaches outsourcing through an economic and managerial perspective, despite a legal perspective having also been developed. Subsequently, under the purpose of this work an analysis was made under the scope of law. In some parts of the second and third chapters, a discussion under the Portuguese Civil Law was also carried out, regarding the comparison of the concept of outsourcing to other established legal figures. Therefore, this approach may be seen as important for further understanding the distinctive characteristics of the outsourcing contract, under an international perspective.

1.2. *Origin and Evolution*

Outsourcing has its roots in the eighteenth century, with Adam Smith's well-known treatise on the division of labour. Evidently, the concept of outsourcing did not exist at that time, but it existed in another way as mercantilism, where markets and transactions developed and became more sophisticated.

Smith built up a basic theory of international trade that "if a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage"[2]. If we here replace "foreign country" with "company", we see a clear contemporary application of Smith's classic principle.

Outsourcing is a management approach which has developed within an economic and political context. After the Second World War, the business model of that time encouraged the establishment of large companies, endowed with many human and material resources, which concentrated themselves in all production phases. Without major technological changes and fluctuations, companies developed their activities in stable markets. In the early 1970's, this scenario began to reverse. The oil crises that led to the instability of markets coupled with technological innovations, dictated a radical change in the business model. In the late 1980's, companies started to follow a new path. In other words, they downsized their internal structures, reduced their resources and engaged in contracts with third parties of non-essential functions, thus developed outsourcing[3].

From an early stage, outsourcing has consisted of three different aspects: production, which has to do with the manufacture of products and components (manufacturing outsourcing) and, information technology (IT) related to, among other things, the network management and development. The third characteris-

[2] A. SMITH, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776.

[3] F. J. CONTRACTOR, V. KUMAR, S. K. KUNDU & T. PEDERSEN, «Reconceptualizing the firm in a world of outsourcing and offshoring: The organizational and geographical relocation of high-value company functions», in *Journal of Management Studies*, 2010, pp. 1428-1431.

tic is related to the business process, the business process of outsourcing (BPO), in which a service provider takes responsibility for a particular area of business such as finance or human resources.

Outsourcing emerged in the early 1960's, when some companies in the area of information technology, began to hire third parties to process their data. However, similarities of features with partnership of today only began to develop in 1980's as company responses to the economic recession and high inflation rates. The 1989 decision making shift of the Eastman Kodak was revolutionary and definitely boosted the outsourcing strategy[4]. The firm hired an IBM subsidiary information technology systems company, ISSC[5]. This managerial strategic option was very wise due to the fact that Kodak[6] is competitive in photography and not information technology[7]. Companies have become aware of the benefits to be gained from outsourcing, such as a greater willingness from management to invest in strategic objectives, the optimization of business processes, cost reduction and risk-sharing. Consequently, certain services or internal functions began to be developed by external suppliers[8]. The continuous need of companies to develop competitive strategies and, to maximize their market positions, came to dictate the strengthening of cooperation between organizations and the consolidation of partnerships.

Thus, the link between the company and the service provider has been transformed, from a simple business relationship to a partnership[9], where trans-

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[4] American incorporated company.

[5] *Id*.

[6] Since 1994, this management tool became even more present in the USA market, with the signing of the NAFTA agreement, which potentiated and leveraged trade relations between American companies and their Northern and Southern neighbours.

[7] J.-N. LEE, M. Q. HUYNH *ET AL.*, «The evolution of outsourcing research: what is the next issue?», in *Proceedings of the 33rd Annual Hawaii International Conference on System Sciences*, 2000.

[8] Facility management encompasses logistics services essential to the functioning of the organization, also called soft services such as cleaning, reception, secretarial work, maintenance, as well as fleet management and purchasing management.

[9] K. KAV & M. KOPER, «What outsourcing can bring in the long run?», Faculty of Management Koper (n.d.).

parency, communication, trust and reciprocity are essential values[10]. They become interdependent because they have common objectives: the satisfaction of customer expectations and the sharing of benefits. Currently, strategic partnerships correspond to the last stage of outsourcing.

We note that unlike the first years, outsourcing has been extended to the core competence of enterprises[11]. Each company, naturally, has its specific objective, but ceases to be essential for the company itself to pursue it. By betting on less possession and deciding to neither retain or create in-house activities, per se more appropriate development of partnerships, companies allow for an increment in the results which are indispensable for maintenance on market. Some authors may argue that organizations became almost indifferent to whether the subject of outsourcing is one of the core activities or any other function. The important thing is to choose a third party that can produce the best results, in any of the functions. Nonetheless, other authors argue that there are business activities that can never be the subject of outsourcing, as, for example, the company's strategic planning, financial department, the supervision of the customer satisfaction and the control of suppliers. Along with the evolution of outsourcing, there have been a few related concepts that have emerged. These concepts derive from the various existing typologies of outsourcing and will later be addressed in this research. We have explored three: the right-sourcing, the in-house, off-site, the co-sourcing and out-tasking.

The "right-sourcing" may mean the right balance between the services or activities that the company decides to keep under its implementation and those that permit third parties to do so. Secondly, the term "in-house" applies when the contracted company performs its activity, at the premises of the contractor company. Thirdly, "off-site" is the opposite concept of "in-house", and in this situation the contracted company exercises its activity on their own premises. Fourth, the "co-sourcing" modality is characterized by sharing the risk of the operation between the contractor and the contracted company. Lastly, the "out-

[10] In the context at stake, this will also involve the longevity of the relationship. The change of partners implies an increase in costs resulting from the adaptation of the new partner, to the business and its specific procedures.

[11] GARY HAMEL & C. K. PRAHALAD, «Competing for the future», in *Harvard Business Press*, July-August issue, 1994.

tasking", is considered as a modified form of the traditional outsourcing. In this situation, the contractor has hired an outsourcing company for performing a task, a function or a specific service.

In recent years, the challenges posed by globalization have led companies to transfer their operational areas to other countries. The permanent search for competitiveness, along with the implementation of policies to reduce costs and the strategic need to enter into new markets, has persuaded companies to divert part of their economy, to other countries that offer considerable economic advantages. A recent study published by the consultant Deloitte (2014) concluded that developing sourcing locations like India, the U.S.A., China and Poland can be expected to see growth of 15%-27%. In addition, other developing sourcing countries like Philippines, Romania, Mexico, Brazil and Malaysia can be expected to achieve higher rates of growth, leading to a potential doubling of the outsourcing market in these countries[12]. The target countries for this transfer were the developing countries.

However, the detractors of this new business strategy present issues in the business world that translate into matters of internal security, as well as, the fear of the lack of quality of services provided in countries with patterns below average. The relocation involves the elimination of jobs in developed countries, and the corresponding exploitation of the labour force in developing countries, which has generated controversy, in several developed countries[13]. In addition, cultural and linguistic differences are regarded by many as obstacles associated with the difficulty in controlling remote operations. These are some arguments against this commercial trend, which is seen by many as a greater economic and social threat to countries, such as the USA where this relocation trend, despite everything, gained strength[14].

The General Electric Co. was one of the precursors of relocation, having approximately 12,000 people working in India, China and Mexico. Many other

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[12] DELOITTE, *Deloitte's 2014 and Beyond Global Outsourcing and Insourcing, Survey 2014*, December 2014.

[13] J. K. HOLCOMBE, «Solutions for regulating offshore outsourcing in the service sector: using the law, market, international mechanisms and collective organization as building blocks», in *Journal of Labour and Employment Law*, Vol. 7:3, 2005, U. PA.

[14] *Id*.

companies have done the same, taking advantage of cheap labour in these countries, motivated by the presence and level of requirement of foreign companies to be ever more qualified[15]. This relocation is also known as offshore outsourcing or offshoring, understood as the outsourcing of functions and services to companies located in distant countries. This model was developed over recent years, as a result of technological progress with the onset of the internet, telecommunications and satellite transmissions.

To provide for the increasing needs of developed countries, ideal destinations have arisen for the hiring of offshore outsourcing. Currently, India is considered as the most appropriate nation for this mode of outsourcing, due to the low cost of labour and high educational levels, particularly in the areas of information technology. Despite its undeniable success, the offshoring constitutes an important challenge for business organizations. However, dissatisfaction has been growing and, generating many situations of "backsourcing", in where the company may opt for a process reversion and produce internal functions previously outsourced. In addition to the already mentioned linguistic and cultural differences, other factors contribute to the failure of many attempts at the offshoring process. This may be related to a few identified factors. One being the increasing risks of operation, which result from the ever greater number of service providers in offshoring. The other being observation costs surpassing estimations or contractual specifications, as a result of global economic and financial instability[16]. Nevertheless, this dissatisfaction has not curbed the development of offshoring. Many companies, contractors and suppliers have reached a certain degree of maturity in their relationships, continuing to invest in this important business strategy.

[15] In 2005, Jack Welch was elected the most admired CEO, in the past 20 years, by the readers of the magazine Chief Executive, and by Fast Company Magazine. See JEFFREY A. KRAMES, *The Welch Way: 24 lessons from the World's Greatest CEO*, McGraw-Hill, 1st ed., 2001.

[16] M. C. LACITY & R. HIRSCHEIM, «The information systems outsourcing bandwagon», in *Sloan Management Review*, Fall 1993, pp. 73-86.

1.3. *The Concept of Outsourcing*

The term outsourcing has an Anglo-Saxon origin and widespread use in the business world, although in certain European countries other terms are used that have the same meaning. The increase in productivity, performance and quality of service are vital factors that determine the success of organizations. As Saunders *et al*. states, "Outsourcing today means many different things to many executives. It may mean a single system contract for the relatively small percentage of the budget, or it may span multiple-systems and represents a significant transfer of assets, leases and staff of a vendor who operates, manages and controls the company's information systems functions"[17].

The definition of outsourcing is not uncontested. We can understand this term in a broader or narrower context. Outsourcing consists of hiring services and activities of a business, from an external entity that specializes in this service. The execution of all the activities and processes relate to an area or function, therefore even day to day management is transferred to this third party. The difference between outsourcing and subcontracting, which will be addressed later in this research, may seem to be non-existent: the literature commonly refers to these terms as being synonymous. Normally, firms resort to subcontracting to satisfy peak demand or the needs of a particular activity or season. As some authors write, there is not a transfer of daily management, but "(...) outsourcing comprises the delegation of the day to day management of the outsourced activity to third parties. It is the element of delegation of management, which differentiates outsourcing from subcontracting. Once the price and service levels have been established, in-house responsibility is to manage the contract rather the activity"[18]. As we can see in the second chapter, we face two realities with different characteristics[19].

[17] C. SAUNDERS, M. GEBELTE & Q. HU, «Achieving Success in Information systems outsourcing», in *California Management Review*, Vol. 39, No. 2, 1997, pp. 63-79.

[18] D. WOOD, P. BARRAR & K. O'SULLIVAN, *Outsourcing Finance Activities: a Practical Approach for Small and Medium Enterprises*, Institute of Chartered Accountants in England & Wales, 1996.

[19] ISABEL DA SILVA FIDALGO, *Outsourcing Contract: A Legal Perspective*, University of Minho – School of Law, 2016, pp. 29 *et seq*.

The relationship of outsourcing is characterized as long-term. Hiring a company of couriers to deliver an order is not outsourcing, but hiring it to deliver all the company's orders for a period of five years is. In a BPO, a company transfers a business function, rather than an activity. There are different outsourcing definitions proposed in literature, but it is often described as being a strategic decision, that encompasses the contracting of external entities to provide certain non-strategic activities or business processes. This is accomplished by means of agreements or contracts with companies, with the ambition of bolstering the competitive advantage[20]. This leads to a discontinuation of in-house processes[21]. Others define outsourcing as "the transfer of the production of goods and services that had been performed internally to an external party"[22].

Although the differences are subtle, there are many variations in outsourcing definitions. In addition, it is important to stress that several types of outsourcing exist, but their general form remains the same. Within all the proposed definitions, it is commonly argued that outsourcing means a discontinuity of the internal processes or activities, which is also known as the make-or-buy decision[23]. Thus, management strategy is of great relevance in the organization's response to the constraints of a competitive market and competition.

2. Corporate Governance and Innovation

A system of corporate governance shapes a company's innovation activity in three main ways: corporate ownership, corporate finance and labour. The first aspect involves the distribution of control rights and residual income rights within the corporation, primarily within the company's ownership structure. Secondly, it is important to mention how businesses finance their innovative

[20] T. F. ESPINO-RODRIGUEZ & V. PADRÓN-ROBAINA, «A review of outsourcing from the resource-based view of the firm», in *International Journal of Management Reviews*, 2006.

[21] T. KERN & L. WILLCOCKS, «Exploring information technology outsourcing relationships: theory and practice», in *Journal of Strategic information systems*, Vol. 9, 2000, pp. 321-350.

[22] L. ELLRAM & C. BILLINGTON, «Purchasing leverage considerations in the outsourcing decision», in *European Journal of purchasing and supply management*, Vol. 17, 2001, pp. 15-27.

[23] I. R. EDVARDSSON, G. K. OSKARSSON & S. VESTEINSDOTTIR, «Enhancing customer services and core competencies: outsourcing in Icelandic service SMEs», in *International Journal of Entrepreneurship and Small Business*, Vol. 14, No. 3, 2011, pp. 313-333.

processes and production teams. The third dimension is related to labour. This has been neglected by the traditional corporate governance research, but, it is considered to be a central concern for corporate governance and performance.

It is widely recognised among legal and economic policymakers that the institutions of corporate governance have a direct correlation to technological development[24]. Technological innovation is vital in order to keep the business growing profits in the long term[25].

In spite of the multiple purposes, there only a few studies that mention the effect of governance structures on the firm's ability to innovate in different research fields. In addition, an analysis at the level of business and organizational strategies should be better integrated into an analysis of what corporate law and labour law establish at a national level. In the corporate context, innovation is the result of companies applying their ideas with the aim to continue to meet the needs and expectations of customers. In addition, organisational capabilities and skills can enable the company to "set the agenda" before its competitors do, to always remain a step ahead. The strategic organisation structure must be defined regarding the type of business environment. It also requires the appropriate combination of strategy, organisation and finance. From the commercial law perspective, it entails the use of legal tools and practices at all three levels of corporate decision-making (strategic, operational and transaction level). This reasoning must always be kept. Otherwise, it will not lead to the intended ambitions.

As we have seen, company resources can be obtained and organised internally, or acquired from the market externally. The literature generally refers to this process as the option of a firm to choose to hire resources through contracts of outsourcing as a make-or-buy decision. As we have seen, a company's innovation process may be costly and time-consuming. Customers expect service suppliers to suggest innovation and to not wait for customer's ideas for

[24] W. LAZONICK, «Corporate Governance, innovative enterprise, and economic development», paper prepared for the UNU-WIDER project on Institutions and Economic Development, 2005.

[25] N. BASSETT-JONES, «The Paradox of Diversity Management, Creativity and Innovation», in *Diversity, Management, Creativity and Innovation*, 14 (2), 2005, pp.169-175.

innovation. In sum, outsourcing customers are eager to reap the benefits of an innovation in technology and a mature process to achieve success in their own business. However, this need for innovation conflicts with the main weapon of providers of this service: the price. Innovation is a very expensive process[26].

Companies organize themselves in different ways, namely by evaluating which activities should be available in-house and which activities may be outsourced. This last option may entail the mitigation of agency problems. The question is, "What types of outsourcing actually exist?".

3. Types of Outsourcing

The various types of outsourcing are defined in terms of several classification criteria. If the criterion used is the scope of outsourcing, we will find two possibilities: total outsourcing and selective or partial outsourcing. A total external hiring involves at least 80% of the organization's functions; partial outsourcing involves an assignment of less than 80% of functions.

Another criterion is the one that "(...) measures the level of decision or the level of the intensity of the relationship, between the contracting company and the contracted party. This criterion refers to operational, tactical and strategic outsourcing"[27]. Through this classification, it is possible to observe the increasing intensity of the relationship between the organization and the supplier of services. Within the business process of outsourcing, the literature commonly refers to three different types that reflect the geographic location of the contracting parties, namely offshore, onshore and nearshore. The offshore outsourcing indicates the relocation of a business function from one country to another. This may involve the manufacture of products, service centres or other operations to a different country. Offshoring is often employed to reduce the cost of doing

[26] M. C. LACITY, S. SOLOMON, A. YAN & L. P. WILLCOCKS, «Business process outsourcing studies: a critical review and research directions», in *Journal of Information Technology*, 26, 2011, pp. 221-258.

[27] F. FRANCESCHINI, M. GALETTO *ET AL.*, «Outsourcing: guidelines for a structured approach», in *Benchmarking: An International Journal*, 10 (3), 2003, pp. 246-260.

business, looking for the company to move part of their operations to countries with more favourable economic situations[28].

There are other decisions that may be taken by a company, with the aims of reducing costs and, improving quality and competitiveness. However, none of these should be confused with the concept of outsourcing[29].

4. Comparison Between the Concepts of Subcontract and Outsourcing

There are similarities between these two concepts, and in fact some authors consider them to be synonyms[30]. As we will explain later, we may face two scenarios with different characteristics. In part of the First Chapter[31], we saw a definition for the concept of outsourcing, but it is also worth analysing the subcontract concept.

The European Union defines subcontracting as the situation that results from a contract concluded between a company called the "main contractor" and a company called the "subcontractor"[32]. Thus, it is agreed that in the implementation of another contract concluded between the "subcontractor" and a third party called the "subcontracted", it must deliver goods or provide services that the "subcontractor" will incorporate in overall deliveries that have been ordered by the main contractor. At the legal level, the "subcontracted party" is not a signatory of the contract concluded between the principal contractor and his/her "subcontractor". Therefore, it is possible to observe a derivation and dependence on another previous consent of the same nature, which constitutes the basis or main agreement. The results strictly have a correlation with the

[28] Blended-shore is a combination of onshore with offshore outsourcing. This option requires selecting a partner that can leverage their multiple locations to provide a coverage of scale, services, and savings. The outsourcing company makes the investment, for instance the construction of contact centres, in several countries, staff, its management and its maintenance.

[29] ISABEL DA SILVA FIDALGO, *Outsourcing Contract: A Legal Perspective*, pp.17-26.

[30] S. PIZARRO NÓBREGA, *O contrato de Outsourcing*, 1st ed., Wolters Kluwer Portugal and Coimbra Editora, 2010, pp. 55 *et seq*.

[31] See supra note 29.

[32] E. COMMUNITY, 82/854/EEC: Council Decision of 10 December 1982 «on the rules applicable, in the fields of export guarantees and finance for export, to certain subcontracts with parties in other Member States of the European Communities or in non-member countries», (L), 1983, p. 2.

birth and contents of the second. In other words, it can be said that subcontracting occurs when the subcontractor concludes a contract with a third, without unlinking the corresponding usefulness to its contractual position. Such a legal relationship presupposes the existence of two contracts: the basic and the derivative[33].

Departing from a broader definition of industrial subcontracting, it is designated as the operation whereby a company (contractor) entrusts to another (subcontractor) a certain task[34]. This is executed in accordance with a set of specifications or pre-established requirements, a part of or all of the whole of acts of production of goods or certain specific operations[35].

The OECD considers two main forms of subcontracting to exist: subcontracting of structural, cyclical or occasional. The structural subcontracting is reflected in the strategic decision by the company to call upon the expertise of other companies outside the group, to establish a permanent and regular relationship[36].

The cyclical or occasional subcontracting is the temporary employment of another company as a way to get goods and services that the first firm normally produces, but has momentarily stopped producing. Thus, it is done within certain conditions of the product and time limits previously agreed upon by the parties. It can be argued that this cyclical nature of subcontracting may correspond to what we define as outsourcing, which is the supply of goods and services previously produced internally in the contracting company, differing only in the occasional character mentioned above.

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[33] O. GOMES, *Contratos*, 26th ed., Rio de Janeiro, Editora Forense, 2009, p. 168.

[34] M. M. Leitão Marques, *A subcontratação na comunidade económica europeia*, Oficina do CES, Coimbra, 1990, p. 2.

[35] However, there are several modalities of subcontracting according to various criteria, such as, among others, the distinction between subcontracting cyclical or structural, of capacity or skill, labour or production, domestic or international, with recipient determined or undetermined, among others. See C. DAS C. EUROPEIAS, *Guia Práctico sobre os Aspectos Jurídicos da Subcontratação Industrial na Comunidade Europeia, Parte I*, Vol. I, Serviço das Publicações Oficiais das Comunidades Europeias, 1992, p.15.

[36] OECD, *Measuring globalisation: OECD Handbook on Economic Globalisation Indicators*, 2nd ed., 2010, pp.201-202.

Outsourcing presupposes a lasting relationship, unlike subcontracting where we observe contracts for the short and medium term. Through the simple comparative analysis of these definitions in relation to outsourcing, we can derive obvious differences.

First and foremost, it is possible to note that we find contractual relations, unlike in outsourcing. In fact, the subcontract assumes a contractual sequence, the main contract concluded between the "main contractor" and "subcontract" company, and the second contract concluded between the latter and "subcontracted" party, which is in charge of the implementation of the whole or part of the subject of the first contract.

Moreover, it can be inferred that this contract is an ancillary contract to the extent that it depends on a main contract, which principally features the same content. In relation to the subject of the contract, there is an identity of the subject between the derived and main contracts, being that the scope of the subcontract cannot be wider than that of the base contract and is in fact usually more reduced[37].

On the one hand, it is possible to verify the existence of a contract in outsourcing. On the other hand, the outsourcing company does not perform all or part of the subject of the contract, but it usually performs certain functions or services before being internally conducted at the firm.

Therefore, is possible to conclude that instead of two parties being involved, as happens in the outsourcing contract, we always find three intervening parties in a subcontract: the "main contractor", the "subcontractor", and the "subcontracted"[38].

Regarding the characteristics and size of the companies involved, the subcontractors are often similar to those companies that outsource. Usually, these subcontracted companies are smaller and less well-equipped than the contracted companies which have more resources and technological means.

The types of relations between companies also differ. Outsourcing is described as being an immersive, deeply engaging relationship of partnership, between the contracting and the outsourcing company. In addition to providing

[37] P. MARTINEZ ROMANO, O *Subcontrato*, Almedina, 1989, (2nd ed. 2016), pp. 95-101.
[38] *Id*., pp. 34-37.

human and technological resources, outsourcing also seeks to increase productivity as well as quality standards of the contracting company. Outsourcing firms also share the risks and benefits of the activity or process at stake. Therefore, the specialization of these companies enables efficiency in boosting the production of the contracting company.

In subcontracting, however, the subcontractor limits itself to making available its resources for the good of contractual execution. In this case, the relationship is purely commercial, not involving any partnership. Thus, we see that the "main contractor" has no relationship with the "subcontracted" party, due to the intermediate contractual figure between them, the "subcontractor"[39].

Some authors sustain that the difference between outsourcing and subcontracting relies on the transfer of control[40]. In subcontracts there is no transfer of control of the activity or process. The ownership of the business process remains with the "subcontractor" company, which indicates and sorts the form and complete instructions of how the service is to be provided. On the other hand, in outsourcing contracts, there is a transfer of control, whereby the contracted company exercises its activity with complete autonomy. The way the objectives are achieved is laid down in the contract, and the outsourcing company acquires full responsibility. After this analysis, it is possible to identify differences that might be autonomous enough to consider two figures that are not normatively typified[41].

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[39] See supra note 37.

[40] J. TUM, P. NORTON & J. N. WRIGHT, *Management of Event Operations*, Event Management Series, Elsevier, 2006, p.120.

[41] In the current Portuguese Civil Code, the subcontract not merited typification as contractual form. The legislator has defined only two subcontracts, subleasing (Article 1060) and subcontracting (Article 1213, para. 1), not meaning that, by virtue of the application of the principle of contractual freedom, that there can be no other subcontracts.

5. Analysis of Subcontracting Concept in Light of Portuguese Law and that of Other Jurisdictions Within Existing Frameworks of Contract Types

The objective of this research is not to develop specific issues from any one jurisdiction in particular, but to provide some comparisons with other legal figures with which outsourcing may resemble, and to make an analysis of the law. For that reason, we will undertake a comparison, taking as its point of departure the Portuguese legal framework, namely, the Portuguese Civil Code (CC) from Chapter IV to Chapter XIII[42].

The Portuguese Civil Code does not treat the subcontract as an autonomous figure[43]. Therefore, it would be advantageous for the case law, and especially the doctrine, to concentrate on this figure to find the common elements needed to outline a structure, and to perhaps draw up a general theory of the subcontract[44]. With only a few exceptions, neither Portuguese nor foreign legal doctrine have shown themselves prone to admitting the need to formulate a general theory of the subcontract. It has even been stated that despite many subcontracts presenting peculiar characteristics, the construction of a general category would be artificial and could not explain the true nature of the subcontract. Following this reasoning, we subsequently consider that each of the contractual figures should be studied separately, but that a total unitary study of the subcontract is not feasible. In recent years foreign researchers have written

[42] See ISABEL DA SILVA FIDALGO, *Outsourcing Contract: A Legal Perspective*, *cit.*, pp. 69-71.

[43] The same occurs in other diplomas of civil law, such as the Brazilian, Spanish, French, Italian, German and Swiss. See OECD, *Measuring globalisation: OECD Handbook on Economic Globalisation Indicators*, *cit.*, pp. 201-202.

[44] In addition, there are certain specific aspects and effects which would involve themselves in itself an autonomous treatment with respect to the general theory of the subcontract. Moreover, also the possibility of relationship between subjects who are parties in different legal relations comes to demand the creation of a unitary discipline of the subcontract. Only this unitary discipline can explain the role of the intermediary in two relationships in which is part and, especially, the possibility of third parties, in particular some legal business, be sued by one of the parties in the contract on the basis of liability obligational relationship. Thus, it becomes necessary to seek the common denominators of subcontratual phenomenon. Both national and foreign doctrine does not have shown propensity to admit the need to formulate a general theory of the subcontract. See supra note 7, p. 18.

monographs on the subcontract, which exposes the need for the creation of an autonomous discipline[45].

Although the outsourcing contract entails, in many cases, a provision of services, it does not, however, fall within the concept of contract for the provision of services, as established in Article 1154 of the Civil Code. The contract for the provision of services is one that a party undertakes to provide to the other certain results of his/her intellectual work or manual, with or without remuneration. The essential difference between the two figures lies in the compensation aspect. While in the contract for services there may or may not be retribution, in an outsourcing contract, there is always a payment, because it is an onerous contract.

The representation mandate and working contract or contracting agreement are, in accordance with Article 1155 CC, two of the modalities of contract for the provision of services. The Article 1157 CC tells us that the mandate is a contract by which a party undertakes to practice one or more legal acts for the account of another. The essential characteristics of this contract rely on the fact that the mandate has always as its object the practice of one or more legal acts, being that the legal act should be practiced on account of the principal[46]. By considering the aforementioned, it is possible to find a fundamental difference between the two. In other words, in the outsourcing contract the provider acts on his/her own account, and not on account of the contracting company[47]. As mentioned, the outsourcing contract is onerous and mandate representation is presumed to be free of cost, implying costs only when practiced by a lawyer or solicitor.

The notion of contract is amended by Article 1207 of CC and describes it as being a contract where one party agrees with the other to carry out certain work with determined price. Moreover, a works contract requires the completion of construction within a specific and previously, determined span of time. The concept of completing a work should be understood not only as the construction or the creation, but also as the repair, modification or demolition of an

[45] P. MARTINEZ ROMANO, O *Subcontrato*, *cit.*, p. 19.

[46] See supra note 45, pp. 33-36.

[47] Article 1178 of the Portuguese Civil Code entails this representation mandate aspect.

object[48]. In the outsourcing contract, the outsourcing company provides a specialized service that is not to be confused with this concept of work.

Another relevant aspect is related to the issue of autonomy. In a subcontract agreement, the "subcontracted" party has a certain degree of autonomy from the owner of the works that has hired him. On the other hand, the "subcontracted" party is also subject to the rules of the art or profession, such as for architectural or engineering requirements, within the framework of the implementation of this work. In an outsourcing relationship, this subjection is not found. Furthermore, another difference that can be observed is related to the price. As can be observed in paragraph 2 of Article 1211 CC, concerning the payment of the price, or in paragraph 1 of Article 1216 CC, concerning changes to the work, these consubstantiate considerable differences are compared to the contract of outsourcing[49].

In the current Civil Code, the subcontract has not merited a classification as contractual form[50]. The legislation only defines two subcontracts, these being the sublease and subcontracting, in Articles 1060 and 1213 CC, respectively. The subcontract may be qualified under Portuguese law as sale, performance of services, works or even as an atypical or "mixed" contract, which combines elements of other contracts. However, this does not mean that by virtue of the application of the principle of contractual freedom, that there can be no other subcontracts (article 405 CC paragraphs 1 and 2).

If we consider the observed countries it is possible to see that the subcontract is not subject to a typical and named contract, lacking for this reason, a specific normative discipline[51]. In a large percentage of European jurisdictions, subcontracting is regulated by the general rules of the respective Civil Code and the general laws of the contractual 'type' in that best fits, depending on the case

[48] In relation to the characterization of the works contract, see L. MENEZES LEITÃO, *Direito das Obrigações*, Vol. 3, 6th ed., Almedina, 2008, pp. 511 *et seq.*, and see supra note 45, pp. 103-108.

[49] This issue is developed in the next topic.

[50] ISABEL DA SILVA FIDALGO, *Outsourcing Contract: A Legal Perspective*, *cit.*, pp. 68-71.

[51] See C. DAS C. EUROPEIAS, *Guia Práctico dos Aspectos Jurídicos da Subcontratação Industrial na Comunidade Europeia, Parte II*, Vol. 292, Serviço das Publicações Oficiais das Comunidades Europeias, 1992.

in question[52]. After an analysis of some of the legal aspects of subcontract, present in some European jurisdictions, the situation described above is common within several jurisdictions[53]. Thus, the subcontract is governed by the general rules of the Civil Code and by the contractual 'type' that best fits depending on the cases.

Today, there are standard contracts on subcontract drawn up by business organizations or large companies, such as *Verband der Deutschen Automobilindustrie* (Union of German Companies in the automotive sector). However, these do not have great diffusion outside the sector to which they are related. Nevertheless, they tend to impose such contractual clauses to their subcontractors. Both parties may have an interest in trying to conclude a written appropriate contract that governs the specific form and consensual fundamental aspects of their relationship. In the absence of a solution of this nature, the contract shall be governed in many cases, by general contractual clauses imposed by the other party. However, in its absence or in respect of aspects not covered by these general clauses, the legal standards of Civil Code of the jurisdiction at stake may be applied, but with a relative uncertainty that may subsist.

Most often, the foreign subcontractor is forced to accept the general clauses, which are usually previously established and in a manipulative manner by the other party. This constitutes another reason for which the foreign subcontractor may constantly try to safeguard, in any form, the possibility of negotiating a specific contract *ad hoc* to regulate the subcontracting relationship[54].

All things considered, subcontracting is usually temporary and may involve, for instance, subcontracting with a third party to execute a relatively small project. On the other hand, outsourcing is usually permanent. It takes the form of the decision that a certain function is alien to the company's core activities, and that the subsequent engagement in a contract with an outsourcing company is to manage this function for them. Subcontracting is an older term,

[52] In line with the provisions of the relevant conventions, that the jurisdiction in question has ratified. See supra note 50, p. 64.

[53] The jurisdictions covered in this practical guide are Germany, Belgium, Denmark, Spain, France, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and United Kingdom, see supra note 50.

[54] P. MARTINEZ ROMANO, O *Subcontrato*, *cit.*, p. 30.

which traditionally refers to the practice of hiring an outside company or provider to perform specific parts of a business contract or project. Therefore, a company subcontracts another company to perform an activity which cannot be executed in-house. The "main contractor and the contracting" party throughout the project have a reasonable amount of control over the process. Outsourcing, however, involves contracting operations of specific business processes, with the aim of boosting production. Thus, there is a host of services or processes usually associated with marketing, legal services, bookkeeping, financial services, business consulting, logistics, innovation (R&D), human resources, payroll, data entry and/or call centres. Subcontracting and outsourcing are two operations management strategies that are intended to reinforce the operation of a company or business. However, they may have slight differences between them. Due to the demands of economic life, and to the intensification of relations of force which determine the contractors and subcontractors, we are witnessing a trend toward the subcontracts being concluded without sometimes a real negotiation between the parties. However, these contracts acquire a pivotal position in relations between companies, because increasingly each contractual clause must be analysed with accuracy. Before addressing the contract of outsourcing it is important to understand the legal issues in the outsourcing process, which may arise at each step of the process[55]. It is also paramount to elaborate on a complete and flexible SLA in accordance with the inherent outsourcing contract. This behaviour leads to a reduction of common issues arising in an outsourcing contractual relationship[56].

6. Conclusions

Today, outsourcing has become a common management practice among companies. Throughout this analysis, we observed that through outsourcing, companies can minimize their costs, by the transfer of an activity or process to

[55] ISABEL DA SILVA FIDALGO, *Outsourcing Contract: A Legal Perspective*, *cit.*, pp. 39-66.
[56] *Id.*, pp. 75-90.

an external third party, which will be an extended arm of the contracting organization or a partner[57].

However, although the outsourcing agreement contains the provisions freely settled by both parties, there are certain national laws of the contracted company's jurisdiction that will be deemed applicable. Therefore, these ought to be considered when drafting the contract and inherent service-level agreement (SLA). As precaution, these issues must be evaluated though a structured stages approach. Because the outsourcing contract acquires specific complexities, which distinguish it from the subcontract, there may be obstacles to the creation of a unitary figure. The main conclusions of this essay translate into the following:

1. The multijurisdictional outsourcing relationship acquires peculiar contours and entails a myriad of legal risks. Thus, there are circumstances in which the legal enforcement may be weaker, since some of the applicable laws do not provide the same level of protection. In addition, it is interesting to observe that one of the most outsourced activities or processes are related to IT and intellectual property rights, and beforehand parties know that several complexities, in addition to unpredictable ones, will emerge.

2. Throughout this research, we developed a comparison between the concept of outsourcing and other legal concepts, with which the former has resemblances. Nevertheless, it is possible to conclude that, the outsourcing concept acquires contours that enable us to distinguish it from the subcontract. The subcontract has not been classified as a contractual form. If we consider some previously mentioned European jurisdictions, it is possible to see that the subcontract is not usually subject to a typical and regulated contract, lacking a specific normative discipline. In a large part of European jurisdictions, subcontracting is regulated by the general rules of the respective Civil Code and the general laws of the contractual 'type' that it best fits, depending on the circumstances. Considering this it is possible to observe some legal uncertainty associated with subcontract qualification. Therefore, in subcontracts parties will often opt for the establishment of their own contractual terms. In the outsourcing

[57] See supra note 53, pp. 81-90.

multijurisdictional relationships, the parties may also opt to define their own contractual terms due to the (system's/practice's) inherent complexities.

3. In the literature we find authors who argue that a substantial analysis shows the relative autonomy and specific characteristics of this contractual practice. This leads to the need to rethink the nature of State intervention in the public and private economies. Companies should not achieve this change through pure abstention, but rather through adapting to recent technological and organizational changes in production systems. Moreover, it is stressed that a new model should not only be characterized by a relative shrinkage of intervention of imperative means, but also by greater consultation and negotiation, with the recognition of the capacity for self-regulation of private entities. In order to benefit from offshoring and offshoring and international outsourcing, Europe should also increase the flexibility of its labour markets.

4. In short, there is no standard form to handle outsourcing agreements. However, it would be plausible to observe the implementation of guidelines, on behalf of the European Union, as a complement to a few indirect outsourcing related directives. Thus, reaching a consensus and an agreement which directly concerns these matters ought to be a priority for national bodies, to harmonize, and to contribute to the development and safeguard of ownership rights.

5. Therefore, the creation of standard guidelines regarding each activity or process of outsourcing should be envisioned, to contribute to the development and safeguard of ownership rights of foreign or national companies. Through the intervention of these public entities, business or company organizations may have more substantial knowledge about these commercial relations, in each jurisdiction. Harmonization of the practices ought to occur on the legal levels of protection and enforcement, within jurisdictions. This may represent an attempt to constitute specific standards, which would be sustained by a good contractual governance, as well as a sense of trust and commitment, contractual flexibility and effective communication. Otherwise, opportunistic behaviour may result, along with the eventual failure and termination of the contractual relationship. This would be more plausible, rather than an eventual juridification of the concept of outsourcing, as in the case of subcontract.

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Software Interoperability: EU Competition and IP Legal Framework

João Novo Faria Lages *

1. IP Focus

1.1. *The Copyright*

In what concerns interoperability (a service that allows for information exchange and products connection), we must take into special account the copyright and trade secret.

Copyright, unlike patents, only protects against the copying of a work, but it does not protect the ideas embodied in that work, the functionality. To be given copyright protection, originality must exist. According to the Berne Convention, the work of an author is protected during his/her lifetime and fifty years beyond that[1]. However, it could have a longer period of protection. For example, under European law, the work is protected during the author's lifetime and for another seventy years[2].

Directive 2001/29/CE is focused on copyright in the European Union and aims to harmonize aspects related to copyright and rights related to technological developments in the information society; this directive primarily deals with

* Master degree in European and International Business Law at University of Minho (Braga, Portugal).

[1] Article 7 of Berne Convention

[2] See CATHERINE SEVILLE, «Copyright and Related Rights», in *EU Intellectual Property Law and Policy*, 2009, p. 58, and M. LEHMANN, «Property and Intellectual Property – Property Rights and Restrictions on Competition in Furtherance of Competition», in *International Review of Intellectual Property and Competition Law*, 1989, p. 8.

three main subjects: reproduction rights[3], the right of communication[4] and distribution rights[5].

Another important directive is the 2009/24/EC Software Directive that deals with the legal protection of computer programs.

We can say that the ideas that remain in the intellect, or in the mind of a thinker, should not have protection, but the ideas that "leave" the author's intellect and are transferred to a written or material form, to a tangible source, could be candidates for protection.

In what concerns the new applications of copyright like in the software market, things have become even more complicated, and the differentiation between an idea/expression is increasingly more difficult to discern. The program code that has the function of giving "orders" to the computer is protected as literary work, but the idea of a software and the functions that it performs are not. To illustrate, if there is a software that gives instructions to a computer to make a cup of tea, the code that constitutes the software is protected, but the idea of making a computer serve tea is not. Essentially, this means that a programmer can create a different code with the same objective (to make a cup of tea), and the code will be protected.

The choice of the commands and algorithms may be protected by copyright, but the ideas and algorithms themselves are not. Likewise, interfaces are formed from both copyrightable and non-copyrightable characteristics. For instance, the expression of the algorithms chosen may be copyrightable, while on the other hand, interfaces also have functional characteristics that would be more prone to patent protection than copyright[6].

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[3] *http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1446042606029&uri=URISERV:l26053*, last seen in 07/04/2018.

[4] See *supra* note 1.

[5] *Ibid*.

[6] PETRA HEINDL, «A Status Report from the Software Decompilation Battle: A Source of Sores for Software Copyright Owners in the United States and European Union?», in *TLF Working Papers*, 2008, pp. 9 and 10.

1.2. *Competition & Intellectual Property*

EU competition rules deal with four categories of potentially anti-competitive actions. The first category is the agreements between competitors (Article 101 TFEU); the second category is the abuse of a dominant position (Article 102 TFEU)[7]; the third category is the Mergers (EMCR)[8] and the fourth category is the State Aids (Articles 107-109 TFEU).

The main objective of Article 101 TFEU is to eliminate cooperation agreements, decisions and concerted practice that influence and distort competition at the EU level.

All agreements that have price fixing, exchanging information on future behaviour, sharing market quotes, limiting outputs, limiting sales, imposing fixed or minimum resale prices, and imposing export bans as their objectives, as well as all agreements that disrupt competition in general, will fall under the scope of Article 101(1) TFEU.

Moving along to Article 101(3) TFEU, we can see that there are some exceptions to the application of Article 101(1) TFEU.

Article 101(1) TFEU shall not be applied if four conditions are fulfilled[9]. The first two conditions are positive while the last two are negative.

(1) It must contribute to improving the production or distribution of goods or to promoting technical or economic progress, (2) while allowing consumers a fair share of the resulting benefit. Additionally (3) it must not impose concerned restrictions on the undertakings that are not indispensable to the attainment of these objectives, and (4) shall not afford such undertakings the possibility of eliminating competition in a substantial part of the products in question.

Given the above, we can see that these two articles are of extreme importance to the interpretation of Intellectual Property rights. These two compe-

[7] RICHARD WISH & DAVID BAILEY, *Competition Law*, Oxford University Press, 2015, p. 175.

[8] See PETRA HEINDL, «A Status Report from the Software Decompilation Battle...», p. 829.

[9] See *supra* note 8, p. 83.

tition law articles are especially useful when differentiating between competition and IP rights.

IP law and antitrust law were created to correct imbalances in the market[10]. IP law was created to incentivize innovation, R&D[11] (research and development) and to protect private investors. Normally the products of such development are made public (to generate profit), and if unprotected, this would lead to reproductions from other companies. The problem arises when these companies copy a product where they did not contribute to any part of the costs for the research and development of the product. The research and development of a product usually leads to high expenses: for staff, materials and time. Protecting the investor will give him/her the opportunity to receive returns for the expenses made, and possibly profit.

High protection in the field of IP could lead to negative effects on competition. Many anti-competitive actions from large companies focus on the invalid enforcement and exercise of IP rights. This happens when companies with more power impede market access through invalid IP rights and licensing agreements[12] that restrict innovation[13].

The balance between IP rights and anti-trust law is a delicate subject[14]. It has been established that protective anti-trust laws cause detrimental effects to innovation as well as to R&D. Companies would not want to spend a large amount of money if they were then to come face-to-face with rivals who copy their products without punishment. On the other hand, if higher protection is given to IP rights and soft, lenient antitrust laws are in place, large companies are likely to impede other market players from entering or competing in the free market.

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[10] GUSTAVO GHIDINI & EDWARD ELGAR, *Intellectual Property and Competition Law*, 2006, p. 99.

[11] Something important for the society evolution and mankind as specie.

[12] GONZALEZ BEGOÑA, «Compelling Disclose Software Interoperable Information», in *The Journal of World Intellectual Property*, Vol. 16, 2013, pp. 6-9.

[13] S. SCOTCHMER, «Innovation and Incentives», in *MIT Press Cambridge*, 2004, p. 134.

[14] See Case C-73/95, Judgment of the Court (Sixth Chamber) of 24 October 1996, *Viho Europe BV v Commission of the European Communities*, pp. 37-38.

The *Microsoft* case is a good example of how the authorities interfered in an IP rights situation which proved to be detrimental to competition.

Microsoft did not disclose interoperability information of their PC operating system, which is crucial for internet browsers to function efficiently. Furthermore, *Microsoft* created an internet browser (*Internet Explorer*) that benefited directly from that interoperability mechanism within the operating system. Microsoft had the dominant position in the market of operating systems, which they used to their advantage to "sell" another product that was not an operating system but instead an internet browser, casting aside the other browsers. The Commission ruled in favour of the other browsers, obliging *Microsoft* to disclose interoperability information so that other internet browsers could gain access to the market[15].

The European Union's approach concerning the new technology market is one of reluctance and control. Dominant companies are not required to disclose the interoperability information of its systems. However, when the access to such interoperability is used to gain market power in another field or market, it will probably be considered an anticompetitive measure[16].

The technological market is one that raises problems with the balancing of IP and antitrust, because within this market, there is usually one or two dominant companies that are likely to gain access to other markets while restricting them for their competitors. According to the author, the intervention of the Commission is necessary at this moment to control the market failures. A problem can arise because dominant companies will be obliged to disclose their technology to rivals; this could possibly lead to a decrease of research and development, and therefore, act as a disincentive to innovate.

[15] Case T-201/4, Judgment of the Court of First Instance (Grand Chamber) of 17 September 2007, *Microsoft Corp. v Commission of the European Communities*.

[16] See: *Antitrust: Commission confirms sending a Statement of Objections to Microsoft on the tying of Internet Explorer to Windows*, at: *http://europa.eu/rapid/press-release_MEMO-09-15_en.htm*, last seen in 07/04/2018.

2. Interoperability

2.1. *Interoperability Context*

Companies normally evolve independently of their rivals, but in the technological world, this is not the case. Let us consider, for example, a computer game. The creator of the computer game needs to gain access to the interoperability interfaces of the operating system so that the game can run in perfect conditions. However, without this ability to exchange information, the game would not run.

Now let us imagine an enterprise that produces operating systems for smartphones wants to enter the market. We will call this enterprise "*newos*". *Newos* is free to enter in the market, but the problem it faces is that all the apps that are now available for *iOS* and *Android* will not be available in the *Newos* store, and consumers are reluctant to change from the security that *iOS* and *Android* currently provide. Consumers already know how the operating systems work, and they know that they have thousands of apps available in their respective stores.

The technological market is often controlled by a few dominant companies that, if not regulated, can disrupt competition, R&D and innovation. If interoperability information is not provided for those who want to create a new product in the downstream markets, it could lead to vertical restraints and foreclosure of an entire market, giving indirect monopoly power to companies in the downstream market that are dominant in the upstream market.

2.2. *Interfaces/Decompilation/Reverse Engineering*

Software: software is the set of instructions that makes the hardware work, transforming the useless machinery into the interactive tool to which we are all so familiar[17]. The most well-known to the general public are: *Mac*, *Windows* and *Linux*. These are the operating systems, the software. We can also have

[17] See Directive 2009/24/EC, paragraph 10. «Reverse Engineering of Software for Interoperability and Analysis», in *Vanderbilt Law Review*, 1994, p. 149.

other types of software like application programs. These programs are, for example, the internet browsers that we use to access the internet, media players, word programs (*Microsoft office word* and *Pages*), among many others.

The operating system has multiple functions. It connects these application programs to the hardware and links the machinery to the application program even though these application programs are often developed by companies that are completely separate from the company that developed the operating system *per se*. However, the distinction between application program and operating system is sometimes unclear and thus, hard to define[18].

A computer program can only read binary code, that is, it can only read ones and zeros, called the *object code*, but this type of code is uninterpretable to humans. The programming language was then created, that is, the object code was transformed into *source code* (written orders and commands) that is readable[19] to humans. For example, to shut down your PC (if you have the *windows* operating system), you can type "shutdown/r/o" and this written command in English has an object code behind it that is composed of a binary code consistent with a specific combination of ones and zeros that corresponds to this action and gives the order for the computer to shut down[20].

The operating system, however, is not distributed in source code, but rather, it is distributed in object code. As Dr. Ashwin van Roijen pointed out, source code is often compared to a recipe, and "one may enjoy a dish prepared according to a recipe that cannot easily be extracted from the meal"[21]. But unlike the recipe, we can extract the source code from the object code to which we have access by decompilation, or the act of reversing the object code into readable source code (usually the source code is not open).

Interoperability is achieved through interface access. Interface in the computer sciences is the point where control between two devices is achieved,

[18] Case Comp/C-3/37.792, *EC Commission v. Microsoft*, pp. 800-813.

[19] PAMELA SAMUELSON, THOMAS VINJE & WILLIAM CORNISH, «Does Copyright Protection under the Software Directive Extend to Computer Program Behaviour, Languages and Interfaces?», in *European Intellectual Property Review*, *n.d.*, p. 159. See also «Reverse Engineering of Software for Interoperability and Analysis», *cit.*, pp. 149-50.

[20] See Article 9 (2) TRIPS Agreement.

[21] See Commission Regulation 2349/84 of 23 July 1984, p. 12.

either between the user and the operational system, between the hardware and the application programs or between two applications. The interface in the hardware is the physical connection that forms the bridge between two devices; the USB connections that we are familiar with are a perfect example. Interfaces in software systems are known as APIs (application program interfaces), and these APIs are essentially codes and messages used by programs to communicate with each other[22] [(for further development please see Directive 2009/24/EC (10)].

APIs are divided into two parts: the interface *specification* and the interface *implementation*[23]. The interface specification is embodied in the object code of the program, detailing the instructions for interacting with the program. The interface implementation is the practical part of the interface, the part of the interface that makes the interoperability with other programs. One part is the theory, and the second is the practice.

One way of accessing the interface's interoperability is through *reverse engineering*[24]. Reverse engineering can be explained with the recipe example. To illustrate, one can eat a very tasty meal prepared by a famous chef and realize that the recipe has vinegar, salsa, salt, pepper, cheese, etc. and knowing this, the person can go home and try to reproduce the recipe. However, that person does not know how the meal was prepared; this person does not know the exact dosages of the ingredients, the length of time it took to cook the meal, or even if there were special ingredients used that escaped his analysis.

Now, one can ask about the legality of reverse engineering[25]. The answer lies in Directive 2009/24/EC (on the legal protection of computer programs). Reading the directive, we can comprehend that unauthorized reproduction or transformation is unlawful except when it is made to gain interoperability ac-

[22] See *supra* note 21, p. 34.

[23] See *supra* note 22, p. 15.

[24] PAMELA SAMUELSON, THOMAS VINJE & WILLIAM CORNISH, «Does Copyright Protection under the Software Directive Extend...», *cit.*, p. 27. See also «Reverse Engineering of Software for Interoperability and Analysis», *cit.*, pp. 150-154, and JONATHAN BAND & MASANOBU KATOH, «Interfaces on Trial 2.0», in *The MIT Press*, 2011, pp. 18-19.

[25] For further development see JONATHAN BAND & MASANOBU KATOH, «Interfaces on Trial 2.0», *cit.*, chapter 1.

cess. The knowledge acquired by reverse engineering cannot be used to compete in the horizontal market; that is, to compete in the same market as the product subjected to reverse engineering techniques.

Decompilation is another way of achieving interoperability, but this is a more mechanic way of doing so, and not just an observational method (as the black box method further developed in page 9). Decompilation tries to obtain the source code of a program through the object code, however, because it is very mechanical, it is not very accurate, and this complements the reverse engineering process[26]. The terms for using this method are made explicit in Article 6 of the Directive 2009/24/EC. The legal terms to use Decompilation are almost identical to the ones for reverse engineering.

3. Software Directive and the Interoperability Question

To better understand what was said above, we need to look at the Software Directive (Directive 2009/24/EC) and see what the legal means are, how they give protection to interface, and what the consequences are in terms of competition.

The software directive was created to solve some problems with IT's rapid development. One of those problems was the interoperability and access to interfaces. Despite being a good legal evolution, the above mentioned directive was not enough, and it falls short of the desired *ex-ante* protection. It left the decision to the ex-post protection (the court decisions)[27].

Article 1(2) of the Software directive states: "Protection in accordance with this Directive shall apply to the expression in any form of a computer program. Ideas and principles which underlie any element of a computer program, *including those which underlie its interfaces, are not protected by copyright* under this Directive".

To determine if protection can be granted to interfaces, we should go back to the definition of interfaces and how they are divided; again, interfaces

[26] PAMELA SAMUELSON & SUZANNE SCOTCHMER, *The Law and Economics of Reverse Engineering*, *n.d.*, p. 28.

[27] See *supra* note 21.

are composed of interface specifications, the written part of the interface, and the interface implementation, the practical part of the program[28] or the the expression, which can be protected by copyright according to the Software directive.

We already saw that object code is meaningless to humans and only readable by machines like computers; this brings us to the question: should something that is not understandable by humans be protected as literary work, under copyright laws?

Article 1 (3) of the proposal for a directive implies that the algorithms are not protected under copyright law, leaving some space to facilitate the interoperability and to access the interfaces. However, it did give another way of protecting it – through patents, where they are better suited to protect something that performs a function. The interface does indeed perform a function – the function of interoperability with other programs. A patent also requires usefulness (not a problem) and novelty, and this is where the problem lies. For instance, it would be very difficult to prove the novelty of a certain interface; even if the object codes are different and new, the function of the interface would still be the same.

Recital 11 of the Software directive states that: "For the avoidance of doubt, it has to be made clear that only the expression of a computer program is protected and that ideas and principles which underlie any element of a program, including those which underlie its interfaces, are not protected by copyright under this directive. In accordance with this principle of copyright, to the extent that logic, algorithms and programming languages comprise ideas and principles, those ideas and principles are not protected under this directive. In accordance with the legislation and case-law of the Member States and the international copyright conventions, the expression of those ideas and principles is to be protected by copyright"[29].

This seems to fall in line with the proposal for a directive in which, the expression of ideas is protected under the software directive, but algorithms and programming language are not.

[28] See Directive 2009/24/EC, pp. 150-154; and 173.

[29] See Directive 2009/24/EC, recital 11.

3.1. *Methods to Gain Access to Interfaces*

It can be understood that there was a concern to provide a solution for interoperability between different softwares even if they originate from different competitors and manufacturers.

The directive provides, according to Articles 5(1), 5(3) and 6, the possibility of reverse engineering.

There are two types of reverse engineering that complement each other, the first one is the *black box*[30] method that consists of analyzing from the outside what the program does but not knowing how it does it[31]. The second method, *decompilation*[32], is a more intrusive and mechanical process that tries to obtain the source code through the object code provided by the software[33].

Article 5(1) and (3) provides the legitimacy to engage in the first method of reverse engineering, the black box process.

It is evident that there is legitimacy in observing, studying and testing the software to gain knowledge about how the program works; we have already observed that the ideas underlying the software are not protected by copyright. It is not surprising then, that the software would be permitted to analyze a certain computer program to better understand the functionality of the same program.

However, interoperability is hardly achievable through the black box method; decompilation is a complementary part of the reverse engineering process. Decompilation is also covered in the Software Directive, more precisely in Article 6, and this process does have more restraints.

To engage in decompilation, the program must be reproduced, and indeed, when trying to achieve interoperability, Article 4 of the directive allows for the reproduction of a computer program.

When decompilation is completed and the desired results are achieved, we can expose the know-how that was used to create the software, and this

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[30] For further development see Directive 2009/24/EC, pp. 56-59.

[31] See Commission Regulation 2349/84 of 23 July 1984, p.159.

[32] *Ibid.*, p. 161.

[33] For further development see *supra* note 21, pp. 23-31.

know-how likely has more economic and technological relevance than the original expression of the program[34]. Therefore, Article 6 of the directive makes some exceptions and imposes limits to the decompilation method[35]. First and foremost, Article 6(1) (c) states: "*those acts are confined to the parts of the original program which are necessary in order to achieve interoperability*". There exists a limitation only to proceed with the decompilation within the strictly necessary to achieve interoperability (Please also see Article 6(2))[36].

The information obtained through decompilation cannot be used for purposes other than achieving interoperability[37], which means that the know-how acquired during the decompilation of the object code to source code cannot be used. However, this seems unrealistic; after acquiring knowledge of something, it is practically impossible to remove the knowledge from the person's mind[38].

It seems that the objective here is to pressure the right-holder and the competitor to engage in licensing agreements[39]. On one hand, there is the possibility that the competitor gains access to more than interoperability, like business secrets or valuable know-how's, but on the other hand, there are costs and delimitations to this time-consuming process of reverse engineering.

It would be more practical for the right-holder to impose a date by which they would disclose the interoperability information – let us say, in one year. Then, it would be more favourable for the competitor to wait that year if the time required for all processes of reverse engineering would take, for example, two years.

Concerning the costs associated with this commercial transaction, it could be favourable for both parties. To elucidate, there is the right-holder that gains a time advantage (one year with no competition) as well as revenue from the licensing agreement. Moreover, there is the competitor that does not have to spend money in the reverse engineering process and only has to pay the costs associated with the licensing agreement.

[34] See Commission Regulation 2349/84 of 23 July 1984, p. 83.
[35] See «Property and Intellectual Property...», *cit.*, p. 29.
[36] See *supra* note 35, p.161.
[37] *Rutgers Computer and Technology Law Journal*, Vol. 20, 1994, pp. 335-337.
[38] For further development see *supra* note 21, p. 51.
[39] Article 9 (1) and (2) Berne Convention. See also *supra* note 21, p. 41.

Something that was not taken into account when formulating the Software Directive was the balancing of interests between the right-holder and the competitor. To begin with, we do not have any legitimate way of obliging a right-holder to disclose interoperability information. Articles 5 and 6 of the Software Directive are only a legal way of trying to achieve interoperability, but even when engaging into the reverse engineering process, there is no certainty of achieving interoperability with the decompiled software.

The problem that arises with the decompilation evolution is the know-how disclosure. One way those right-holders can overcome this disclosure can be found in Article 6(1) (b) of the Software Directive that states: "*the information necessary to achieve interoperability has not previously been readily available*". In other words, if the information is readily available for the competitor to achieve interoperability, the competitor cannot engage in the process of decompilation[40]. However, no guidelines are given for the threshold of the amount of "readily available information". Without guidelines, the uncertainty prevails, and more cases need to be solved ex-post instead of ex-ante.

It is important to note that Article 6 (2) (b) of the Software Directive prohibits competitors from coming together to support the cost of the reverse engineering process. This restricts the process of reverse engineering to the richest companies, who have the available funds to invest in this process ("*Shall not permit the information obtained through its application: (b) to be given to others*"[41]). This allows us to see that small and medium companies in this field can eventually be easily disregarded or excluded from the competitive process. In brief, the directive in practice does not provide access to interoperability information to small and medium companies.

Another issue that also goes unaddressed by the directive is the possibility that the right-holders might change the interface specifications at any time. If a company wants to decompile the program and spend time and money in the process, they should at least have a legal certainty to use the decompiled information in the future. If a company successfully decompiles a program, it

[40] See *supra* note 21, p. 62.

[41] See Directive 2009/24/EC.

could be required to do it again for the same program, engaging in new costs for the exact same process and program[42].

3.2. *Should Competition Law Have to Deal with Interface Openness?*

Competition law requires a higher level of protection than IP, but it approaches the problems with more certainty since it is made on a case-by-case basis. Competition law takes into account the details of the specific situation, the economic and legislative problems, and the solution are more reliable.

Competition law interference has negative aspects as well as positive ones. When using an ex-post assessment, we are fundamentally interfering in the legal protection of IP and taking away part of the investors' confidence in the legal certainty. However, the ultimate goal of both IP laws and competition laws is to increase innovation and consumer welfare. The competition authorities must have limited influence when dealing with IP rights, and the intrusion must be minimal.

Furthermore, highly restrictive ex-post control will create barriers to investment and innovation; it could disrupt the market when creating distrust in the legal protection given by pre-conceived laws. We can distinguish the dichotomy between the two levels of protection (the laws in place and the court cases) and realize that an equilibrium point should exist. The objectives pursued by both IP and Competition do not clash, but the tension existing on the level of the protection should be addressed.

When there is an exclusion from third parties due to IP rights, it can eventually lead to intervention by competition authorities. The historical perspective was that the IP rights were on higher ground for protection. In the past, when a tension existed between IP and competition, it was the IP rights that prevailed because of the recognition of a previous right that was given to

[42] See MICHAEL DECK, «Cleanroom Review Techniques for Application Development», in *International Conference on Software Quality*, 1996, p. 36.

the right-holder[43]. Evidently, things are not as conservative as they used to be; today, an economic analysis on the market competition effects is required, especially when there is a foreclosure of a downstream market[44].

4. Recommendations

4.1. *Comparison to the Telecommunications Law*

An analysis of telecommunications law can shed some light on the type of protection we would prefer when dealing with interoperability problems. The issue of using copyright to protect interface specification is the broad scope of protection provided and the apparent lack of suitability[45].

As previously discussed, the same level of protection is given to interface information and the software. It is rather unfair that the software should have similar protection as the interface (whose sole job is to provide interoperability).

When giving copyright protection, it is given to the market players, whose indiscriminate market power must be corrected by the competition authorities in future proceedings. This problem could be corrected in an ex-ante situation as described by telecommunications law, and more specifically in Articles 14 to 17 of Directive 2002/22/EC[46]. First and foremost, this gives a general definition for what constitutes market power (for further developments please refer to articles 14/2[47] and 16/4[48]).

Furthermore, Article 17 provides interesting commentary about interoperability, as it addresses many questions about the standardization of interfaces.

Article 17/2 reads: "Member States shall encourage the use of the standards and/or specifications referred to in paragraph 1, for the provision of ser-

[43] This recognition of primacy to IP law was highly defended in the US courts as can be seen in the cases, *E Bement & Sons v National Harrow Co.*, 186 US 70, 91, 1902, and *Richard S. Simpson, Petitioner, V. United Oil Company of California*, 377 U.S. 13. 310, 1964.

[44] Report by the EAGCP, «An economic Approach to article 82», July 2005, pp. 26, 27 and 28.

[45] See *http://www.wipo.int/treaties/en/convention/trtdocs_wo029.html*, preamble, second paragraph, last seen in 07/04/2018, pp. 79 and 80.

[46] Directive 2002/22/EC.

[47] *Ibid.*, Article 14/2.

[48] *Ibid.*, Article 16/4.

vices, technical interfaces and/or network functions, to the extent strictly necessary to ensure interoperability of services and to improve freedom of choice for users"[49].

Article 17/4 states: "The Commission shall take appropriate implementing measures and make implementation of the relevant standards compulsory by making reference to them as compulsory standards in the list of standards (...)"[50].

We can note that the implementation of standards is encouraged in the first stage, but the Commission reserves the ability to promote mandatory standards.

The copyright protection can be considered an impediment to interoperability since it could hinder the interoperability information and leave the ex-post regulation (case-by-case basis), as the best way to solve growing problems in this field. A court case is usually a very time consuming process with expenses attached to it.

For telecommunications, the solution was to impose a mandatory obligation to interconnect and create suitable and specific ex-ante regulations to enhance the competitive process.

If the lack of ex-ante legislation leads to high market power and dominance, states should be called to legislate and enhance market competition in this field.

Examining telecommunications legislation[51], we can see that at the time of its creation, legislators were aware that the high number of subscribers of one company[52] would lead to a lack of competition and foreclosure of the market. Thus, ex-ante steps like mandatory interconnection were taken to prevent this. Even if there was no previous recognition of the importance of interoperability, it should now be regarded as so, and new forms of regulation should be implemented.

[49] *Ibid.*, Article 17/2.
[50] *Ibid.*, Article 17/4.
[51] Directive 2002/21/EC.
[52] Due to the previous monopoly power given and accepted by States.

To begin with, it is important to note what the natural flow of the market should be with the creation of ex-ante regulations that would possibly generate a competitive market that will then be monitored by competition authorities.

The rules of interconnection according to the Access Directive are permanent[53]. They take into account the relevance of such interconnection not only to disperse the initial high market power and connections that date to the monopoly era but also to increase competition and innovation in the future.

An ex-post protection through competition authority does not give the required ex-ante certainty to new entrants; only ex-ante regulations will do the job. This holds true in the software industry, and an ex-ante protection would be a good way of providing certainty. We should also consider that due to the uniqueness of both sectors (telecommunications and software), specialized regulations and standardization (in interconnection and interoperability) are necessary to increase the competitiveness in both sectors.

4.2. *Telecommunications Law as the Basis for the Software Directive Amendment*

The mechanisms of telecommunications law and the likelihood of a possible amendment to the Software Directive will be further discussed and analysed.

The New Regulatory Framework (NRF)[54] came to supersede the older regulatory frameworks in telecommunications law. The Framework Directive is a first approach to the role of the Commission and of the National Regulatory Authorities (NRA), as the Access Directive is the directive that specifies the access to the networks.

Telecommunications law is aimed at solving temporary and permanent problems of connection and network.

As previously mentioned, due to the different types of industries and their respective network effects, there must be certainty and flexibility because new operators wanting market access must be able to connect with other operators (who already have many subscribers). Flexibility would also be helpful for

[53] Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002.

[54] Regulatory Framework for Electronic Communications.

navigating the complexity of connection costs and the uniqueness of each contract.

Accordingly to Article 4(1) of the Access Directive, a contract must first be drafted between operators:

Article 4(1) states: "Operators of public communications networks shall have a right and, when requested by other undertakings so authorised in accordance with Article 4 of Directive 2002/20/EC (Authorisation Directive), an obligation to negotiate interconnection with each other for the purpose of providing publicly available electronic communications services, in order to ensure provision and interoperability of services throughout the Community. Operators shall offer access and interconnection to other undertakings on terms and conditions consistent with obligations imposed by the national regulatory authority"[55]. This could offer a solution to the lack of mandatory agreements on the interoperability/software area.

When analysing Article 5 of the Access Directive, we can see that the NRF imposes obligations on the NRA to regulate the interconnection between the different market operators. In other words, the NRF can intervene in the negotiations and assure that the different parties of the agreement are developing it correctly and lawfully and that interconnection will be achieved.

Unlike the Software Directive and copyright law, where both grant high levels of protection to the software interfaces, in the telecommunications law, control over the interconnection interfaces is restricted.

Article 5 (1) reads: "National regulatory authorities shall, acting in pursuit of the objectives set out in Article 8 of Directive 2002/21/EC (Framework Directive), encourage and where appropriate ensure, in accordance with the provisions of this Directive, adequate access and interconnection, and the interoperability of services, exercising their responsibility in a way that promotes efficiency, sustainable competition, efficient investment and innovation, and gives the maximum benefit to end-users. In particular, without prejudice to measures that may be taken regarding undertakings with significant market power in accordance.

[55] Directive 2002/19/EC (Access Directive), Article 4 (1).

(ab) in justified cases and to the extent that is necessary, obligations on undertakings that control access to end users to make their services interoperable"[56].

We can see that the NRA has an important role in controlling the application of the telecommunications law and ensuring that the services are interoperable. Increasing and securing effective market competition and interconnection is one of the NRF cornerstones.

The creation of a regulatory authority to control interoperability in software could be an idea to retain from the telecommunications law. It could be a mechanism to ensure that negotiations granting access to interoperability are well conducted.

Another telecommunications method to ensure interconnection that deserves attention is the "reference offer", something that may prove beneficial when implementing it in the Software Directive.

To elaborate, Article 9 (2) reads: "In particular where an operator has obligations of non-discrimination, national regulatory authorities may require that operator to publish a reference offer, which shall be sufficiently unbundled to ensure that undertakings are not required to pay for facilities which are not necessary for the service requested, giving a description of the relevant offerings broken down into components according to market needs, and the associated terms and conditions including prices. The national regulatory authority shall, inter alia, be able to impose changes to reference offers to give effect to obligations imposed under this Directive".

The reference offer is intended to protect the weaker parts that enter into negotiations. It is a clause that ensures non-discriminatory methods of negotiation and accelerates the process. The NRA can intervene in this process, forcing the operators to amend the reference offers. This makes it more difficult for the powerful operators with negotiating advantages to slow down the process, something worth considering for the small players in the software industry.

[56] Directive 2002/19/EC (Access Directive), Article 5.

5. Conclusions

In the final analysis, we can state that interoperability is a subject of major importance in the technological world. The high value of networking in the IT market leads to an ever growing debate on the level of protection that should be given to interfaces.

There are methods to gain access to interfaces, but in the author's point of view, those methods are often disproportionate in terms of costs and effectiveness.

The methods of reverse engineering and decompilation are associated with the Software Directive in Articles 5 and 6. But as we saw, the costs and time spent in those processes do not promise interoperability. The software right holder can change the interoperability information at any time, leaving the other contractual part with more expenses to decompile and reverse engineer the same program. This situation is rather unfair to the contractual part that incurred extra costs for decompiling and reverse engineering.

The Software Directive does not include any kind of obligation to disclose interoperability information. It only provides (non-mandatory) solutions to achieve it. The problem arises when a company does not possess enough monetary funds to engage in activities like decompilation and/or reverse engineering. One might argue that it can negotiate with the right holder to enter into a licensing agreement, but the right holder is not at all obligated to forge an agreement.

We cannot forget to mention that the Software Directive prohibits the disclosure of information achieved through decompilation and reverse-engineering. That is, small companies cannot come together to share the costs of this operation.

Furthermore, competitors cannot engage in the processes of decompilation and reverse engineering when the information is readily available (Article (6) (1) of the Software Directive). The problem here lies is the lack of information for ascertaining the *right* amount of information that needs to be disclosed to prevent these processes.

From the author's point of view, it would be beneficial to change the Software Directive in the following ways: including more detailed information about the quantity of readily available information to be disclosed to prevent decompilation and reverse engineering; allowing competitors to share the costs of decompilation and reverse engineering; giving more certainty to competitors that spend time and money in decompilation and reverse engineering[57].

The author maintains that problems of interoperability should be addressed mainly in an ex-ante situation, leaving the ex-post intervention as little as possible. The telecommunications law is a good starting point and a good reference for making some possible changes to the Software Directive.

First, an article should be implemented where "market power" is defined and where a certain undertaking or joint undertakings have the market power to decrease effective competition. Second, member states should be given the power to correct the market failures and to remove the high market power from the undertaking(s) mentioned above.

Member states should also be given the power to encourage and, if necessary, to mandatorily implement standards of interoperability.

Moreover, member states should be given the ability to impose mandatory obligations to enter into licensing agreements to achieve interoperability. The member states should create a competent authority to give proper and fair values to the agreements mentioned. All recommendations previously stated should have transparency as a cornerstone, giving the public access to information concerning market power, information about interoperability standards and costs of licensing agreements, as well as information about all public interventions made in this sector.

Finally, it would also be important to implement a non-discriminatory clause as well as a proportionality clause to protect undertakings with less influence or monetary power.

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[57] For example, if a competitor decompiles or reverse engineers a program, it should be given a period where if the right holder changes the interoperability information, that information should be granted to the competitor free of costs.

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UEFA's Financial Fair Play Regulations within EU Competition Law

José Pedro Correia Fernandes *

Introduction

In recent times, many clubs have reported financial losses which, in some cases, have increased from year to year. The global economic outlook has created difficult market conditions for European clubs. This can have a negative impact on revenue generation by impacting the availability of funding. Many clubs have failed to comply with their duties, having experienced liquidity problems which have lead, for example, to the delay in payments to other clubs, employees and social authorities, and taxes[1]. UEFA is the governing body of football in Europe and one of the six continental confederations of world football's governing body – FIFA.

Therefore, having this real threat present, the UEFA Executive Committee unanimously approved in September 2009 the concept of 'fair play' mode for the financial well-being of European clubs.

The concept also received the support of the entire football family. Its main objectives are, among others, "to improve the economic and financial capability of the clubs, increasing their transparency and credibility; to place the necessary importance on the protection of creditors and to ensure that clubs

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* Senior Due Diligence Officer (*Anti-Money Laundering & Combating Terrorism Financing*) at BNP Paribas, Lisbon. Master LL.M in European & Transglobal Business Law at the University of Minho – Law School, Dissertation concluded, "The Impact of UEFA's Financial Fair Play Regulations and their compatibility with EU law", 2016.

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[1] Available at *http://pt.uefa.org/protecting-the-game/club-licensing-and-financial-fair-play/index.html* (last view, 30-06-2015).

settle their liabilities with players, social/tax authorities and other clubs punctually; to introduce more discipline and rationality in club football finances; to encourage clubs to operate on the basis of their own revenues; to encourage responsible spending for the long-term benefit of football; to protect the long-term viability and sustainability of European club football"[2].

Financial fair play was approved in 2010, and the first assessments kicked off in 2011. Since then, clubs that have qualified for UEFA competitions (namely UEFA Champions League and UEFA Europa League) have to prove, in simple words, that they have paid their bills. Since 2013, clubs have also been assessed against a break-even provision. This break-even requirement will be analyzed further in my research but, in summary, it requires clubs to balance their spending with their revenues and restricts them from accumulating debts. This assessment is made by the independent Club Financial Control Body (CFCB) for all clubs in UEFA competitions and based on each season from three years' worth of club financial figures. The first sanctions and conditions for those clubs who did not comply with the break-even requirement were effective for the 2014/2015 season.

Nevertheless, although these rules of financial fair play gather a large consensus from most sports entities, there is still some criticism about whether FFP is based on solid legal foundations; recently, a question was raised as to whether or not a court – notably the Court of Justice of the European Union (CJEU) – might strike it down. Most recently, it has been reported that a Belgian football agent made a formal complaint to the European Commission about FFP, alleging that the regulations breach EU law[3].

For that very reason, since 2015, UEFA has been formulating means of perfecting or even 'softening' the rules of FFP so that clubs can attract more sustainable investment while controlling for overspending. It should be noted that the interest of all clubs, in general, is to take part in UEFA's European competitions, since the income that arises with them is a major source of revenue in key

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[2] Article 2.2 objectives, (Edition 2015) Financial Fair Play Regulations.

[3] GUARDIAN, "Players' agent launches legal threat to UEFA financial fair play rules" (06-05-2013), *http://www.guardian.co.uk/football/2013/may/06/agent-legal-threat-uefa-financial-fair-play*.

sectors, vis-à-vis television rights, sponsorship, merchandising and prize money, among others[4].

The preexisting UEFA club licensing system is now updated, combining the previous rules with the FFP provisions, which stipulate that a club must not spend more than it earns. The new instrument, UEFA's Financial Fair Play Regulations and Licensing System, now sets out financial requirements that a club must comply with in order to gain access into UEFA's competitions. The core provision of the FFP regulations' (updated version 2015) is the so-called '*break-even*' requirement – which I will analyze in this piece of research – that obliges, concisely, clubs not to spend beyond their means, not living beyond their means. At first glance, one may say that these new rules introduced by UEFA may appear to be a mere quality standard. Yet, the provision highlighted above – break-even requirement – constitutes a sort of salary cap in the sense that it limits the amount that a club can spend on a player's salary[5].

This creates some serious problems since this salary cap mechanism constitutes, only *per se*, a restriction of competition. For this reason, we must assess whether or not this restriction issued by UEFA violates the competition law of the European Union. This research aims to answer questions raised about possible violations by UEFA's regulations of the Treaty of Lisbon.

Although the European Commission and the UEFA issued a joint statement on the matter, that was not enough to silence the most critical opinions.

In addition, some voices have also raised the question of whether the FFP regulations breach European Union (hereinafter EU) law regarding the free movement of workers, in the sense that if a measure related to employment in professional sports within the EU blocks or discourages individuals from looking for another job in a different Member State, disregarding their nationality, is in risk of violating Article 48 of TFEU[6]. My work will also consider and reflect on this legal issue.

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[4] "Clubs benefit from Champions League revenue" (23-07-2013), available at *www.uefa.com.*

[5] C. A. FLANAGAN *ET AL.*, «A tricky European fixture: an assessment of UEFA's Financial Fair Play regulations and their compatibility with EU law», in *The International Sports Law Journal*, 13(3), 2013, pp. 137-148.

[6] Case C-415/93, URBSFA v. Bosman, 1995 E.C.R. I-4921, §96; Case C-325/08, Olympique Lyonnais v. Bernard & Newcastle Utd., judgement of 16 March 2010, §34.

One should note that it is in the interest of all clubs, in general, to take part in UEFA's competitions, since the income that arises with them is one of the major sources of getting profits, throughout match day revenue, broadcasting revenue and commercial revenue (including merchandising)[7]. This is why CL & FFP rules are so important for them.

I. The Content of Club Licensing and Financial Fair Play Regulations

As stated above, what influenced the Union of European Football Associations to impose the FFP regulations were the concerns regarding the financial health of European football clubs. It is, therefore, no surprise that the objectives of the legal measures imposed by this new instrument target the excessive level of spending by the clubs. Actually, Article 2 of the provisions defines the aims of FFP[8], with additional goals being included on the UEFA official website, which adds that the financial fair play concept was approved in order "to decrease pressure on salaries and transfer fees and limit inflationary effect; to encourage long-term investments in the youth sector and infrastructure"[9].

We can describe these goals as aiming to ensure the financial health of clubs and halting financial doping measures practiced by a large number of agents that make up the professional football industry. It is expected that clubs can replace their financial policy and adopt a new strategy towards a widely held sustainable development, seeking long term agreements that, besides being based on sporting, are branded by sustainable financial health instead of

[7] HAMPUS RIKARDSSON & LINUS RIKARDSSON, *Strategic Management in Football – How the European top club could adjust to UEFA financial fair play and simultaneously create conditions for competitive advantage within the changing UEFA football industry*, Linköping University, Department of Management and Engineering, Business Administration, 2013, p. 41.

[8] UEFA, "Club Licensing and Financial Fair Play Regulations" (2015) at Article 2(2) states that: "to improve the economic and financial capability of the clubs, increasing their transparency and credibility; to place the necessary importance on the protection of creditors and to ensure that clubs settle their liabilities with employees, social/tax authorities and other clubs punctually; to introduce more discipline and rationality in club football finances; to encourage clubs to operate on the basis of their own revenues; to encourage responsible spending for the long-term benefit of football; to protect the long-term viability and sustainability of European club football".

[9] UEFA, *Financial Fair Play*, electronic available at: *http://www.uefa.org/protecting-the-game/club-licensing-and-financial-fair-play/index.html* (last updated, 01-07-2015).

short-term strategies distinguished by several and repeated losses, huge risk and moral hazard.

As it is commonly known, UEFA has laid the foundations of club tournaments. More specifically, it is responsible for organising four club competitions – namely the UEFA Champions League, UEFA Europa League, UEFA Super Cup, and, more recently, the UEFA Youth League[10]. Without exception, all of these European competitions represent the most reputable and profitable events in which a club can take part. The UEFA Champions League is arguably the most prestigious club competition within the entire football industry, along with other major sporting events[11].

More than 1.03 billion euros in winnings were allocated between the top European football clubs in the Champions League edition season 2014-2015. Crushed finalists, Juventus, earned the most earnings of the competition, pocketing a sum of 89.1 million euros. Surprisingly, the last place team, Barcelona, collected smaller amounts than those earned by Juventus, its rival at the Berlin final last year in Germany – the Catalan team garnered around 61 million euros with its participation in the competition.

The most noteworthy win among the English squads was Manchester City (€45.85m), trailed by Chelsea (€39.23m), Arsenal (€36.38m) and Liverpool (€33.59m). An aggregate of €42m circulated among the 20 teams included in the play-offs and in early stages of the competition, the rest being distributed to the 32 associations included in the group stage onwards. Each team is entitled to a minimum of €12m just by participating in the group stage – with the group stage valued at €1m per win and €500.000 per draw. There was extra prize money of €5.5m for entering the last 16, €6m for reaching the quarterfinals and €7m for reaching the semi-finals. Finally, the winners get €15m while runners-up receive €10.5m[12].

[10] See UEFA, *Uefa Competitions*, electronic available at: *http://www.uefa.org/documentlibrary/competitions/* (last visited, 19-02-2016).

[11] See MONTE BURKE, *The Richest sporting events in the world*, Forbes, The Little Book of Billionaire Secrets, *How to turn $20k into $20 million in 12 years or $1,2m in 30 years*, electronic available at: *http://www.forbes.com/pictures/mme45efhm/uefa-champions-league/* (last visited, 19-02-2016).

[12] *Cf.* UEFA, «*UEFA Champion League revenue distribution*», retrieved from: *http://www.uefa.com/uefachampionsleague/news/newsid=1858497.html* (last updated, 31-05-2015).

Notwithstanding this prize cash, groups were likewise honoured with broadcasting revenue commonly known as TV cash[13]. The sum given to every club depended on the corresponding estimation of national TV market and, additionally, on the quantity of clubs from that country in the competition. The capability of generating broadcasting revenue may vary across European football since the signing of new broadcasting contracts differs from league to league[14].

For example, Italy's TV business sector is a huge part of the general scheme. However, there were just two Italian teams in the group stages, and consequently, Juventus had to share that cash with Roma, thereby leaving the competition with the most cash. Meanwhile, Barcelona needed to share its broadcasting revenue channels between Real Madrid, Atletico Madrid and Athletic Bilbao. Likewise, UEFA distributed €2.9m among 19 national affiliations whose members contended in last season's competition[15].

An increase in the Champions League prize money capital for the next three-year cycle 2015-18 was also announced. The difference is significant, with a 50% increase in the "Participation Bonus" which is guaranteed for all 32 teams. The previous amount shared between every team that qualifies for the group stages of champions league will now jump to €12m starting from 2015-16 season[16].

Consequently, with this amount of money involved, it is simple to see why any European club will intend to conform to the regulations. At least, this is specific to those that have the opportunity to qualify for these tournaments through their accomplishments in the domestic competitions, at a national level. Actually, during the 2011/2012 season, 591 of the 730 top-division clubs experi-

[13] DELOITTE REPORT, Top of the table, «*Football Money League*», 2016, Sports Business Group, p. 24.

[14] See *supra* note 7, 5.1.1.2, "broadcasting revenue", p. 19.

[15] HAMISH MACKAY, *The Mirror*, «Champions League Prize money 2014/15 – see how much your club earned last season, electronic available at: *http://www.mirror.co.uk/sport/football/news/champions-league-prize-money-201415-6680392* (last updated, 22-10-2015).

[16] TOTALSPORTEK2, «UEFA Champions League Prize Money 2016 Breakdown», electronic available at: *http://www.totalsportek.com/money/uefa-champions-league-prize-money/* (27-01-2016).

enced the licensing procedure, which relates to a sum of 81% of every single top club[17].

II. The Break-Even Requirement

As mentioned above, the *break-even* requirement will be the central feature of this licensing process of the clubs. Thus, the notion of the 'break-even' result is introduced in Article 60 of the CL & FFP regulations. This clearly defines that "the difference between relevant income and relevant expenses is the *break-even* result, which must be calculated in accordance with Annex X for each reporting period"[18]. Next, clubs should present positive fiscal assessments translated into a positive balance sheet, with more income than expenses. The 'relevant income' and 'relevant expenses' concepts are defined in Article 58 with additional information set in Annex X.

Thus, these concepts highlight some of the most important aspects of the rules that constitute the object of the present research. At a first glance, 'relevant income' is restricted to income arising from football operations[19], which may vary between match day revenues, sponsorship and broadcasting details and profit on players' transfers. On the other hand, 'relevant expenses' include player transfers, wages and related costs along with other operating expenses.

There are also anti-evasion mechanisms like arm's-length trading and related party transaction criteria[20], which will be analyzed with more attention below.

Typically, the '*break-even*' requirement is assessed by considering the three previous reporting periods, with the aggregate of those three periods being the 'aggregate break even result'[21]. There is just an exception in the first monitoring period's assessment, which only considers the two previous moni-

[17] Communications, "Financial Fair Play Media Information" (25-01-2012).

[18] See *supra* note 8, at Article 60, p. 37.

[19] *Id.* at Article 58, no. 1, p. 36.

[20] See G. DANIEL, «The UEFA Financial Fair Play Rules: a Difficult Balancing Act», in *ESLJ*, 50, §9, 2001, p. 2.

[21] See *supra* note 8, at Article 59, p. 37.

toring periods[22]. If the 'aggregate break-even result' is negative, it represents an 'aggregate break-even deficit' for that monitoring period[23].

However, given the financial difficulties that clubs had until the introduction of this new mechanism, UEFA predicted in the article the possibility of clubs to present an acceptable deviation from the break-even result up to 5 million by 2018[24]. From the first 2013/2014 monitoring period, an owner can invest up to €45m over two seasons in exchange for more shares in the club. This means that wealthy owners can only have, after the 2013/2014 season, on average, the opportunity to spend €15m worth of cash for shares, each year, in the club, vis-à-vis on transfers fees, wages, and so forth. That figure is reduced to €10m per season (€30m over three seasons) for the 2015/2016 season. If an owner does not put any money into a club by way of cash for shares, each club's acceptable loss suffers a considerable decrease, being just €5m over three years[25].

III. Sports Special Features

Today, we live within a European dimension, so we must reckon with the Treaty of Lisbon, which came into force on 1 December 2009. It has, at last, brought sport within the explicit scope of the Treaty. Nonetheless, the Treaty of Lisbon has not made any fundamental changes regarding the previous rules, and it emphatically does not offer any sort of binding or comprehensive approach to the topic. One may argue that EU sports law is still an ambiguous creature and that its shape has been molded incrementally over many years, long before the rise of the Treaty of Lisbon.

Once sport has an economic dimension, its practices may be assessed against the broad scope provisions enshrined in TFEU's. The Treaty contains provisions that exert broad control over the function of the whole economy. These include, most significantly, the provisions on free movement of persons

[22] *Id.* at Article 59.
[23] *Ibid.* at Article 60, no. 2.
[24] *Ibid.* at Article 61.
[25] *Id,* at Article 61, no. 2, p.38.

and services and the rules on competition. In this way, EU law has overlapped with 'internal' sports law and sporting conducts must comply with the Treaty.

Since sport has been perceived as having a financial dimension, sporting practices fall within the extent of the Treaty. It encompasses rules that apply expansive control over the working of the global economy. Most essentially, these incorporate the free movement of persons and the freedom to provide service provisions and the provisions based on European competition law grounds. Subsequently, sporting practices must be in accordance with the Commission regulations, and this coincides, partly in time, with the 'domestic' sports law framework.

It is the complex and ambiguous confluence between sporting practices and EU law that has long stimulated my interest in this field. There are issues that need to be addressed, vis-à-vis how legitimate is the EU's claim to subject sporting practices to the rules of the Treaty. The TFEU offers no regulation on the scope to which sport's individual specificities should inform the legal analysis as well as in what way are the frequent appeals of sports federations to be granted autonomy from legal intervention legitimate, given that their decisions frequently carry significant economic implications.

Recent years have shown that the rapid increase in the commercial significance of the sports sector, driven in part by the technological and regulatory reshaping of the broadcasting industry, has brought with it even more willingness to scrutinize the role of law in influencing the choices available to sports governing bodies.

One should consider that EU trade law should not be applied to sport in a way that neglects sport's undoubted special characteristics. For example, clubs in a professional sports league are not competitors with the same nature or characteristics found in the common markets. Sports clubs need opponents; they need credible rivals to compete against. There is an alignment of interdependence among clubs in the same league that is almost cultural. They are strictly linked, which marks the organized sport as culturally and economically different, distinguishing it autonomously.

Some features make competitive sport a special case, and the law should regard that, or otherwise, they will experience justified criticism for insensitive

mishandling of the matter. Instead, some experts in this subject are reluctant once they become skeptical to assume that sport is quite as special as sports federations sometimes claim it to be[26].

Namely, they argue that they cannot approve that the simple finding – practices included in the sporting sector having economic implications – is sufficient to grant its immunity from legal device. This claims favorably to a model that embraces an inevitable intersection between the EU provisions and sports corporate governance, a model which makes sport as subject to EU law but boasts special features which are also relevant to legal analysis. The question lies in deciding where to frame competitive sport because it is based on a compelling claim for a specific treatment. This treatment given by the law recognizes the social and economic special features of sport and where, on the contrary, sports bodies are only focused on defending their own interests.

There is no doubt that sport has its own specificities. The question is to what degree do EU law and policy apply[27]. As a substance of constitutional body enshrined in Article 165 no.1 of the TFEU and a subject of administrative and judicial procedures until the present day, sport is not so singular.

The Nice Declaration on Sport held that "the Community must, in its actions under the various Treaty provisions, take account of the social, educational and cultural functions inherent in sport and making it special"[28]. This does not mean that sport is singular and unique under EU law even though, as many other sectors (agriculture, transport, *inter alia*), it has its own special features that individualizes it from the different industries.

Reference should be made to three important CJEU (then EEC) rulings that show an evolution in the very description and understanding of the sports

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[26] R. SIEKMANN, «Is sport 'special' in EU law and policy?», in *Future of sports law in the European Union: beyond the EU Reform Treaty and White Paper*, R. Blanpain, F. Hendrickx & M. Colucci (eds.), Kluwer Law International, 2008, pp. 37-49.

[27] See, e.g., B. BOGUSZ, A. CYGAN & E. SZYSZCZAK, «Is sport special?», in *The regulation of sport in the European Union*, Edward Elgar, UK, 2007, pp. 3-32.

[28] The Treaty of Nice, agreed by the Heads of State or Government at the Nice European Council signed on 26 February 2001, is the culmination of eleven months of negotiations that took place during an Intergovernmental Conference opened in February 2000. It entered into force on 1 February 2003 after being ratified by the fifteen Member States of the European Union (EU) at that time, according to their respective constitutional rules.

issues made by the Court itself. These serve to frame many of the considerations and factual analysis, illuminating the confusing tensions involved in the formation of the spirit of law. In Walrave and Koch v. Union Cycliste Internationale, the Court treated the composition of national sports teams as unaffected by the Treaty's ban of discrimination on grounds of nationality. It also considered the selection of players to represent a certain international federation – a question of purely sporting interest, which has nothing to do with economic activity.

The outcome was reasonable; there is simply no internationally representative football without restrictions on selection policies. Besides, we must note that football clubs are strictly connected to the country of origin. As addressed in Part I of this piece of research, following national competitions, the top teams are selected to participate in international tournaments. It is key that most of the clubs' players come from their country of origin. The team would be less attractive for its supporters if this were not the case. It would be inexplicable, for instance, for a team such as Barcelona to be composed exclusively of English and German players. If we reach this point, clubs will no longer be affiliated to an area but to a company[29]. National boundaries may delimit the very nature of the business and, in football, they must not be forgotten. They do not simply constitute barriers to trade that impose arbitrary isolation on the market but rather a fundamental tool of the structure and popularity of the entire football industry[30].

Showing respect for the specificity of sports phenomenon on an industrial scale, the Court employed a not very well articulated legal formula. The Court's reference to a matter of interest 'purely sporting' that 'as such has nothing to do with economic activity' is unpractical since the selection rules govern-

[29] VAGELIS ALEXANDRAKIS, «The Sporting Exception in the EC free movement rules», in *Revista de Estudos de Gestão, Jurídicos e Financeiros*, 1st Year, Ed. No. 03 (Jul./Sep. 2010), pp. 91-99.

[30] S. WEATHERILL, «Discrimination on Grounds of Nationality», in *European Sports Law*, Collected Papers, 2nd Edition, ASSER International Sports Law Series, Springer, p. 44.

ing international football federations are clearly of sporting interest[31]. But at the same time, those rules have much to do with economic activity as well.

IV. CL & FFP Potential Legal Challenges Within EU law

The principle legal concerns that UEFA's CL & FFP regulations present under EU law are that they restrict free movement of workers and constitute an anti-competitive agreement. As the FFP mechanism has the potential to impinge upon clubs' economic behaviour, one must assess the potential engagement of Article 101 TFEU once it may impact upon the movement of players between clubs and determine whether there is a breach of Article 45 TFEU; and if Article 101 or Article 45 would normally be engaged in such circumstances, one must consider whether this would be vitiated by the principle of the specificity of sport (or 'the sporting exception', as it is also known).

The point that the CL&FFP regulations generate negative externalities, specifically but not solely for workers and consumers, links it to the examination of EU law, predominantly under antitrust provisions, but possibly also on behalf of the provisions on free movement of workers. Moreover, several experts in the field have pointed out the likelihood of such a dispute, due to the horizontal and vertical competition restraints that the CL&FFP rules would involve[32]. This may have influence under the CAS jurisdiction (and, then, by the Swiss Federal Court), which would have legitimacy to assess cases implicating the CL&FFP regulations. The UEFA has declared that it is operating side by side with the EC regarding the CL&FFP rules.

Nevertheless, it is known – at the latest because of the Bosman case – that such collaboration is not an invincible guarantee against the CL&FFP regulations infringing EU law. Perhaps there will not be anyone to defy the CL&FFP regulations, as the different football participants seem to have accepted them

[31] Case 36-74, B.N.O. Walrave and L.J.N. Koch v Association Union cycliste internationale, Koninklijke Nederlandsche Wielren Unie and Federación Española Ciclismo, Judgment of the Court of 12 December 1974, E.C.R. 1974:140.

[32] A. DUVAL & M. MATAIJA, «European Football Governance – Looking Backward, Looking Forward», *in European University Institute, Global Governance Programme*, Issue 2013/03, p. 3.

and the EC's position supports them. However, there is a demand to thoroughly consider the compatibility of the CL&FFP regulations with EU law[33].

Considering that no overall exception for sporting rules from EU legal framework would be accessible – and that CL&FFP regulations are likely to impact a restriction on the free movement of athletes – by the 'salary cap' it designs – and on competition as well, the main issue is their justifiability: separately from the reasonably limited justifications stipulated by Article 101(3) of the TFEU, a rule characterized by restrictively affecting competition that might be admissible only if those are intrinsic to the lawful objectives chased and do not go further than what is needed to attain it.

Firstly, is it pointed out that UEFA implemented a legal instrument that restricts competition in the players' market options and imposes the decrease of salaries' weight in the budget – like a US salary cap – but deprives players of compensation via earnings from increased competitive balance[34]. Secondly, the UEFA held provisions that sacrifice potential welfares arising from equity injections from wealthy owners[35], also known as 'sugar daddies', into football accounts[36]. Lastly, it is also mentioned that UEFA issued a guideline that will 'fos-

[33] *Cf. Id.*

[34] *Cf.* T. PEETERS & S. SZYMANSKI, «Vertical restraints in soccer: Financial Fair Play and the English Premier League», Research Paper nº 028/2012, University of Antwerp, Rottenberg, 2012, p. 7.

[35] "The FFP restrictions limiting sugar daddy investment appear to be a backdoor method to accomplish what American closed leagues can directly regulate. Ownership in closed leagues is by definition at invitation only. All leagues have regulations as to who may own a team, and they also place some restrictions on the activities in which the owners may engage. The NFL, for example, enforces the most severe restrictions on ownership. They ban large publicly traded corporations from retaining teams. This policy allows the league to be comprised of only individual owners, creating a relatively homogeneous group. The NFL also proscribes majority owners from also holding an MLB, NBA or NHL teams located in NFL home cities. New owners of existing franchises in American leagues typically require a super majority vote of the current owners, for instance 75% approval in MLB. Those desiring to buy teams are sometimes famously denied", in J. MAXCY *ET. AL.*, *The American View on Financial Fair Play*, Philadelphia, Pennsylvania, USA, ESEA Conference Volume Oxford, UK : Peter Lang International Academic Publishers, 2014. p.15

[36] P. MADDEN, "Welfare economics of "Financial Fair Play", 2011, in a sports league with benefactor owners, forthcoming in: *Journal of Sports Economics Journal*, 2015, Vol. 16, No. 2, pp. 159-184.

silize'[37] or 'petrify'[38] the hierarchy of European football, creating a barrier to entry[39]. It is the purpose of this piece of research to address namely the second one, with the others being sub adjacently considered.

V. Outline of the Possible Justifications: The Wouters Exception

Regarding the purpose of this piece of research, it will now be analysed if any justifications can be applied to the CL & FFP regulations to avert a statement that they are void[40].

The main purpose of this chapter is to scrutinize whether the statutory concession enshrined in Article 101(3) of the TFEU or the judicially drafted *Wouters* exception, apply to the CL & FFP regulations. The UEFA regulations will not infringe Article 101(1) if either of these exceptions applies. Next, it seems coherent to illustrate the main disparities amid these two statutory concessions. The so-called *Wouters* exception permits the comparison of non-competition aims against impacts in competition and determines that the first overrule the second[41]. Furthermore, it can be argued that the provisions are not deemed to influence competition that is incompatible with the common market, even if they would otherwise restrict it[42]. When this happens, there is no breach of Article 101(1) TFEU since the final element – whether the agreement has the object or effect of restricting competition – is not fulfilled.

In addition to the *Wouters* judicially drafted exception, we find Article 101(3) of the TFEU to be a competition legal exception. The trust of Article 101(3) is considering and matching the pro and anti-competitive impacts of the

[37] H. VÖPEL, «Do we really need financial fair play in European Club Football? An Economic Analysis», CESIfo DICE Report, 2011, pp.55-58.

[38] M. SASS, «Long-term Competitive Balance under UEFA Financial Fair Play Regulations», Working Paper No. 5/2012, Otto von Guericke, University Magdeburg, pp. 10-11.

[39] H. VÖPEL, «Is Financial Fair Play really justified? An economic and legal assessment of UEFA's Financial Fair Play rules», in *Hamburgisches WeltWirtschaftsInstitut* (HWWI) no. 79, 2013, pp. 3-15.

[40] Article 101(2) TFEU.

[41] See RICHARD WISH & DAVID BAILEY, *Competition Law*, Oxford University Press, 7th ed., 2012, Chapter 3, pp. 130-131.

[42] *Id.*

behaviour at stake, and concluding whether or not it is cost-effectively advantageous to consent the behaviour, notwithstanding its anti-competitive effects[43]. Where behaviors like an agreement, a decision or a concerted practice fulfills the criteria of Article 101(3), it stipulates that the agreement or decision in issue might be exempted from Article 101(1).

In the *Wouters* Case, the CJEU initiated its judicially created exemption, considered by Wish as a 'regulatory ancillary'[44] and by Monti as a 'European-style rule of reason'[45]. The decision does not actually represent the full picture regarding the Article 101(1) legal framework, since the assessment of the positive and anti-competitive outcomes of restrictions comprises of economic altercations on both sides. Instead, *Wouters* presents the evaluation of the EU's competition law aims with the non-economic public interests that might (or might now) be deemed as a part of the EU's goals in other fields[46]. The *Wouters* test was confirmed in the sporting case of *Meca-Medina*.

In relation to the justification of anti-competitive agreements under Article 101 TFEU, the CJEU in Wouters adopted a procedure that is quite similar to the Gebhard test[47]. In that case, the CJEU found that an anti-competitive agreement does not fall under the prohibition laid down in Article 101(1) TFEU when:

- it is necessary to achieve a legitimate objective[48] and "whether the consequential effects restrictive of competition are inherent in the pursuit of those objectives and are proportionate to them"[49].

Therefore, following Meca-Medina and its predecessor Wouters, we are left with a significant number of problems when applying it to the CL&FFP – predominantly regarding the contentious BE requirement and the TPO ban – so

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[43] COMMISSION NOTICE, Guidelines on the application of Article 81(3) of the Treaty, (2004/C 101/08), para.11.

[44] See RICHARD WISH & DAVID BAILEY, *Competition Law*, *cit*.

[45] *Cf.* GIORGIO MONTI, «Article 81 EC and Public Policy», in *Common Market Law Review 39*, Issue 5, 2002, pp. 1087-1088.

[46] *Cf.* K. PIJETLOVIC, «EU Competition Law and Sport», *in EU Sports Law and Breakaway Leagues in Football*, ASSER International Sports Law Series, Springer, Chapter 5, 2015, p. 154.

[47] Case C-55/94, Gebhard v. Consiglio dell'Ordine degli Avvocati e Procuratori di Milano, E.C.R. 1995:411, para. 37.

[48] *Cf.* Case C-309/99, Wouters *et al.* v. Algemene Raad van de Nederlandse Orde van Advocaten, E.C.R. 2002:98, para. 97.

[49] Case C-519/04 P, David Meca-Medina and Igor Majcen v Commission para. 42.

that it may establish itself as not contravening Article 101 TFEU, and therefore not constituting an illegal restriction on competition[50]. In addition, it should be analysed whether or not the CL & FFP pursue legitimate objectives, if the restrictions imposed are necessary to pursue the final goal of financial sustainability within European football clubs and if the provision is proportionate to accomplish it[51].

In addition, a closer look is given to the legitimate objectives of the CL & FFP regulation and their *indispensable* restrictions. The *proportionality* of the regulations (namely the *Suitability* test, the Necessity test and, finally, the *Proportionality/(stricto sensu)* test, after a closer look at art 101 (3) TFEU) was also taken into consideration in this piece of research to provide a clear picture on the topic.

VI. A Closer Look At Article 101(3) TFEU

The European football upper governing body, UEFA, might also pursue protection under Article 101(3) TFEU, which stipulates a concession to a breach of Article 101(1) TFEU. Article 101(3), in its important statements, writes that the provision in question is 'inapplicable' when the anticompetitive procedure at issue "contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit (...)"[52]. Additionally, the behavior must not "impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives" or "afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question"[53].

[50] J. LINDHOLM, «Can I please have a slice of Ronaldo? The legality of FIFA's ban on third-party ownership under European union law», in *The International Sports Law Journal*, 15(3), 2015, p. 143.

[51] T. J. JEMSON, *For the Love of Money, Football, and Competition Law: An analysis whether UEFA's Financial Fair Play breach European competition law*, University of Otago, 2013, pp. 26-28.

[52] COMMISSION NOTICE, Guidelines on the application of Article 81(3) of the Treaty, OJ C 101, 2004.

[53] Article 101(3) a), b) TFEU.

If an agreement or a behaviour that breaches Article 101(1) TFEU complies with these conditions, then it "shall not be prohibited, no prior decision to that effect being required"[54]. These agreements "are valid and enforceable from the moment that the conditions of (Article 101(3) of the Treaty) are satisfied and for as long as that remains the case"[55]. According to the EC's interpretation, this Article 101(3) TFEU criteria amount to an evaluation of pro and anticompetitive effects, and only the four conditions enforced by the provision are considered[56]. Each prerequisite will be separately scrutinized here to conclude whether UEFA's CL & FFP regulations would qualify for this defence.

We must also note that likewise the test established by the CJEU in *Wouters*, an anticompetitive decision can be justified – and it is possible for the CL & FFP regulations to be exempt from the anti-competitive violation of article 101(1) TFEU – if it fulfills the conditions set in TFEU Article 101(3). This provision contains four cumulative criteria that must be fulfilled, with the first two demanding an affirmative answer and the former two a negative one.

The EC's interpretation in this provision is very rigorous, and there are insufficient block exemptions for particular situations. Correspondingly, four conditions need to be achieved when these do not operate: efficiency gains; fair share for consumers; indispensability of the restrictions; no elimination of competition[57]. These criteria are cumulative, and all need to be consequently met for an exemption to be applicable. As mentioned before, the exclusion only operates to measures improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit. Moreover, Article 101(3) requires that the measures be 'indispensable to the attainment of these objectives', meaning that the restraints

[54] Council Regulation (EC) No. 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty (Text with EEA relevance), OJ L 1, 4.1.2003.

[55] COMMISSION NOTICE, Guidelines on the application of Article 81(3) of the Treaty, OJ C 101, 2004, paras. 97-100.

[56] *Id*.

[57] COMMISSION NOTICE, Guidelines on the application of Article 81(3) of the Treaty, OJ C 101, 2004, para. 34.

are essential[58]. Finally, the decision must not afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

VII. General Conclusions

Throughout my thesis research, the implementation of UEFA financial fair play is treated as an empirical starting point for further analysis of how the European top club could adjust its strategy in order to achieve a competitive advantage, keeping in pass with the changes in UEFA football industry. Instead of looking backwards to scrutinize the reasons for financial fair play, the investigation intends to look forward and analyze the club's opportunities for upcoming strategies, providing my critical point of view and some guidance about the topic.

The fact that the rules of financial fair play were only designed in 2009 and implemented in 2010, and that each monitoring period to clubs involves waiting three years to collect the necessary information, proves to be a challenge in trying to analyze the success of rules of FFP within a short time of effective implementation. Another limitation that caught my attention at this early stage of my research was the fact that the European Court of Justice has not yet given its opinion as to whether or not the rules of FFP violate the European standards of competition law. Therefore, since I have to wait for ECJ's decisions about the above issue, my position is lacking legal basis by the European institutions, and this uncertainty represents another limitation to my research.

Regardless of these blocking points, it is concluded that UEFA constitutes an association of undertakings and that the CL &F FP rules comprise a decision of that association. In addition, it is concluded that the CL & FFP regulations will affect trade between member states in an appreciable way. It is also assessed whether they possibly comprise a restriction of competition as their ob-

[58] JEPPE GRUNNET MIERITZ & EINAR MARSTEEN HELDE, *A legal and economic analysis of UEFA's Financial Fair Play Regulations' effect on the competition in European Football*, Copenhagen Business School, March 2014, p. 38.

jective and, even if a court did not rule that this was their main objective, the CL & FFP mechanism would have the effect of restricting competition. The final chapter encompasses the legal analysis by outlining whether there are any possible justifications that would preclude the infringement of Article 101(1).

The *Wouters* exception would most probably be activated and find the restriction of competition held in Chapter Two to be compatible with the market. This is because that restriction of competition complies with every criterion set in the judicially created exemption. This chapter also presents that a legal dispute under Article 102 TFEU would not be fruitful, as UEFA did not constitute an abuse of dominant position when they enforced the mechanism.

To conclude, this research establishes that the CL&FFP regulations are welcome, but, inevitably, the ultimate verdict lies within the judicial procedure. Nevertheless, there are other factors that might preclude the assessment of the provisions as the contractual bound between the European football upper governing body - UEFA - and its members: the predetermined duty to arbitrate at the clear ban of appeal to the European courts; the tacit and explicit agreement of the members under UEFA’s control; and the support vindicated by the EC[59].

[59] For a further understating, please do not hesitate in reverting to JOSÉ PEDRO C. FERNANDES, in *The Impact of UEFA's Financial Fair Regulations and their compatibility with EU law*, University of Minho – School of Law, 2016.

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Transfer pricing and the arms' length principle in the European Union law

Maria João Maurício *

PART I

1. The Transfer Pricing Concept

The concept of transfer pricing, accepted both internationally and within the European Union, is the universal method for determining the right pricing to be used among related parties and, therefore, is used by the Organization for Economic Cooperation and Development (OECD), the United Nations Tax Committee (UN) and also in the tax treaties concluded by the governments.

Transfer pricing – the pricing policies and practices that are established when physical goods as well as services and intangible property are charged among associated business entities[1] – is traditionally used in international tax law as the principal method for allocating income across jurisdictions.

As previously described, multinational enterprises (hereinafter MNEs) represent a substantial fraction of the global trade and industry. Therefore, a challenge that they face is the articulation of the decision-making process among their several subsidiaries, which are located in different countries. Consequently, some can argue that transfer prices are frequently deployed to separate complex decisions among different decision makers by delegating responsibilities among different agents.

In addition to this coordination function, transfer pricing is also used for tax purposes, namely as a device for international tax planning. In fact, taxable

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* Master in European and Transglobal Business Law; Tax Consultant at Deloitte Belgium and Deloitte Portugal.

[1] ANDREW LYMER & JOHN HASSELDINE, *The International taxation system*, 1st ed., 2002, p. 159.

group profits are, often times, allocated among the participating companies by adjusting transfer prices. The main goal for a MNE is to maximize its overall profit; consequently, MNEs will try to allocate profits to a low tax country and losses to a high tax country by frequently shifting their profits to low tax legislations to reduce the group's overall tax burden. In other words, it can be said that the transfer pricing mechanism is a tool often used by corporations to avoid high taxation in certain countries[2].

Transfer pricing is based on the closely related fundamental principles: 1) companies with permanent establishments or affiliated companies in other countries must compute the profits of the different units on the basis of separate accounts (separate entity approach – hereinafter designated as "SA") and 2) for goods and services exchanged by them, prices have to be charged as if they were among independent persons (arm's length principle). In relation to the first condition, it is important to notice that there are certain differences between the treatment of permanent establishments and subsidiaries but, notwithstanding this fact[3], the "*functionally separate entity*" approach adopted by the OECD[4] further gives equivalent treatment to permanent establishments and to subsidiaries. In fact, according to François Vincent[5], a concern for the tax authorities "(...) *has been to maintain a level playing field with respect to the use of a branch or a subsidiary to carry on business in a given jurisdiction. It only makes sense to apply the same principle in both situations, and the arm's length principle was selected*".

[2] To illustrate, consider the following example: the branch of a multinational company builds a car at a real cost of 30,000€, sold on the market at a price of 50,000€. In a high tax rate, for instance, 30%, the manufacturing company should pay a pay of 6,000€ (20,000€ of profit x 30%). To avoid the payment of taxes in the producing country, the subsidiary sells the car for 40,000€ to another branch (located in a more relaxed tax area) that will put the product on the market. In this country the corporate tax rate of 10%. This means that the income tax of the companies group will be 4,000€ (10.000€ x 30% + 10,000€ x 10%), achieving a significant saving of resources. In another perspective, for the producing country, this situation creates a significant loss of tax revenue, GEORGE MATEI & DANIELA PÎRVU, «Transfer Pricing in the European Union», in *Theoretical and Applied Economics*, Vol. VIII, No. 4, 2011 (557).

[3] A critical approach about this treatment can be seen on COUZIN, «The OECD Project: Transfer Pricing Meets Permanent Establishment», in *Canadian Tax Journal*, 53, 2005, pp. 401-408.

[4] Report on the Attribution of Profits to Permanent Establishments, 2006.

[5] FRANÇOIS VINCENT, «Transfer Pricing and Attribution of Income to Permanent Establishments: The Case for Systematic Global Profit Split (Just Don´t say Formulary Apportionment», in *Canadian Tax Journal/ Revue Fiscale Canadienne*, Vol. 53, No. 2, 2005, p. 411.

The main reason companies started to use transfer pricing was to help identify which parts of the enterprise are not performing well, to escape double taxation when repatriating profits and, ultimately, to reduce tax[6]. Despite the recognition that intra group companies frequently try to minimize their costs through the manipulation of transfer prices, this is not always the case, since the leaders of those companies may also have reasons to carry on their management in normal market conditions and reproduce open market schemes in their intra group relations[7].

2. The Arm´s Length Principle

The arm's length principle (ALP) is the method recommended by the OECD which, in its Model Tax Convention on Income and Capital, has adopted the arm's length standard in Article 7, related to the business profit, and Article 9, on associated enterprises[8].

In fact, the OECD Transfer Pricing Guidelines (hereinafter TPG) released in 1995, was the culmination of the efforts made by the international tax community to review the existing standard and adapt it to the modern business world. The OECD Transfer Pricing Guidelines[9] made it clear that the concept of transfer pricing should not be confused with tax fraud or tax avoidance even though transfer pricing transactions may be used for these purposes[10].

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[6] ROHATGI ROY, *Basic International taxation: Volume II*, 2nd ed., 2007, p. 239.

[7] HUBERT HAMAEKERS, «Can Free Negotiation of Prices within a Multinational Enterprise Serve as an Arm's Length Standard?», in *International Transfer Pricing Journal*, Vol. 4, No. 1, 1997, pp. 2-4.

[8] Model Tax Convention on Income and Capital, OECD Committee on Fiscal Affairs, 1992, updated as of 1st September 1995.

[9] The OECD Guidelines are, as their title suggests, merely guidelines and, therefore, most countries have developed their own transfer pricing rules and methodologies, EDUARDO A. BAISTROCCHI, *Transfer pricing in the 2th century: A Proposal for both developed and developing countries*, 2005, University of California, *apud* NERISSA HASKIC, «The Arm's Length Principle and the CCCTB: Solutions to transfer pricing issues for individual countries and the European Union?», in *Revenue Law Journal*, Vol. 19, Issue 16, article 6, 2009.

[10] MICHELLE MARKAM, «Transfer pricing of intangible assets in the US, the OECD and Australia: Are profit-split methodologies the way forward?», in *University of Western Sydney Law Review*, 8, 55, 2004.

Alongside Article 9 of the OECD Model Double Tax Convention[11], Article 9 of the UN Model Treaty of 1980 also regards the arm's length principle as its basic standard.

The arm's length principle, established in Article 9 of the OECD Model Tax Convention, is framed in this way: "*conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly*". In paragraph 2 of Article 9, the corresponding adjustment is established, undertaken as part of the mutual agreement procedure, by mitigating or eliminating double taxation. A transfer pricing adjustment can be defined as the recognition, for tax purposes, of the actual transaction and the assignment of income among associated enterprises. In contrast, a transfer price of the transaction is the adjusted price, which includes the profits of one enterprise in the profits of an associated enterprise. The first involves a pure redistribution of profits among taxpayers, namely, the increase in the profits of one taxpayer is balanced by the decrease in the profits of the other. Therefore, a transfer pricing adjustment means either an income that will be imputed (whenever the transfer price is below the price established by the arm's length principle) or an income that will be reduced in the case where transfer price exceeds the arm's length price.

In this context, OECD Member States have completed some agreements to consent to adjustments for tax purposes whenever the correction of distortion is needed and, thereby, guarantee the effectiveness of the arm's length principle.

The wording of Article 9(1) of the OECD Model and the Commentary does not disclose their main purpose, even though the analysis of paragraph 11 of the commentary of Article 25 of the OECD Model indicates that the reason for inserting the provisions like Article 9(1) in a treaty is to cover, within its scope,

[11] It is important to highlight that this Article 9 is the base for the most bilateral tax treaties involving OECD member countries and for an increasing number of non-members when dealing with transfer pricing.

economic double taxation[12]. This is also indicated by its relationship with Article 7(1)[13] and Article 8 of the OECD Model and its strategic location – among these distributive articles[14]. In addition to this main purpose, it also aims to prevent tax evasion and tax avoidance as well as an equitable inter-nation allocation of taxing rights[15] (although, it does not govern the allocation of the taxing rights of the contracting states over a specific income category).

2.1. *Why the ALP?*

Under this framework, the question that can be raised is: *why have the OECD member countries favoured the arm's length principle rather than other methods?* The OECD's answer stands in the simple reason that this principle provides, in a broad way, similar tax treatment for multinational enterprises, coupled with the efficiency that this standard is supposed to work in a great majority of cases[16].

According to the OECD, the ALP expresses an international consensus – it must prove to be the most effective way to combat transfer pricing. In recent years, many developing countries have introduced or strengthened arrangements for combating tax avoidance, including abusive transfer pricing. However, the great majority of poor developing countries do not have the resources to apply the complex and time-consuming checks on transfer pricing demanded by the OECD's approach.

[12] Article 9 is concerned with economic double taxation caused by transfer pricing adjustments (in the absence of taxpayer identity). The basis of such double taxation may be a legal or factual nature: legally Caused economic taxation may be due to the application of different allocation norms in domestic tax laws of the contracting states; factually caused economic double taxation may arise due to the disagreement of the contracting states in relation to the facts applicable to a specific allocation norm applied by both states, and it may be resolved by the mutual agreement procedure in Article 25. Contrastly, Article 7 of the OECD Model governs international juridical double taxation of business profits.

[13] One difference is that Article 9(1) governs the taxation of an item of income between two taxpayers whereas Article 7(1) governs the taxation of an item of income of one taxpayer.

[14] Article 9(1) provides for a quantification of income between associated enterprises to which the contracting states are ascribed taxing rights according to the genuine distributive articles, which determines the amount of business profits from transactions between associated enterprises.

[15] OECD Transfer Pricing Guidelines, Preface, paragraph 7.

[16] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Report of July 1995 with supplements, Chapter 1.7 *et seq*.

Despite the merits mentioned above, the OECD is also conscious about the shortcomings of this principle. One problem normally pointed out is its insufficiency related to the separate entity approach, which may not always be suitable to the economies of scale and the interrelation of the diverse activities carried out by integrated businesses. Another main disadvantage regards the type of transactions that related enterprises can carry out that the independent enterprises cannot undertake[17]. Consequently, this creates difficulty in the application of the arm's length principle in some cases due to the insufficient evidence of the conditions that would be established among independent enterprises. It is true that transactional methodologies seem to be the most direct way to determine transfer pricing. However, among other downsides, the difficulty lies in finding identical transactions that can be compared to the one in question. These problems are particularly relevant in cases concerning intangible items since there is simply no comparison. This topic will be addressed in more detail below.

2.2. *Transfer pricing methods of the OECD*

To determine the ALP, OECD TPG recommends various methods to establish whether the conditions imposed by parties are consistent with the ALP. According to the OECD guidelines, there are five different methods for determining the transfer pricing which can be categorized into two main groups: the traditional methods based on the analysis of the transaction (the "Transactional Traditional Method") and the method based on the analysis of the profits (the "Transactional Profit Method").

[17] In the case of impossibility to estimate the profit potential of an intangible, it may be certain that the independent enterprise does not want to sell it. On the contrary, if a transaction of this kind is undertaken by a multinational enterprise group, the risk is not the same since the profit stays within the overall group's profit.

PART II

3. The Transfer Pricing and the Arm's Length Principle in the European Union

3.1. *Brief Introduction*

At the European level, it is more precisely Article 4, paragraph 1 of the Arbitration Convention of 1990 that embodies the arm's length principle. In fact, in the European Union framework, the legal defiance against the transfer pricing rules is based on the treaty provisions, which constitute the European Internal market, and particularly the fundamental freedoms set up in the Treaty on the Functioning of the European Union (hereinafter TFUE)[18].

In 2002, the European Commission created the EU Joint Transfer Pricing Forum with the goal of approaching and harmonizing the rules related to transfer pricing, to be practiced in the member states, through the creation of non-binding normative provisions of easy workability. In April of 2004, the European Commission proposed a Code of Conduct to eliminate double taxation in cross border cases of transfer pricings. The proposed text would ensure a more efficient and uniform application of the existing rules and define the procedural rules.

As a result of the few developments due to the lack of coordination between the Commission and the Council, the case law of the European Court of Justice (ECJ) has been playing an important role in the harmonization of the corporate law at the European level. The ECJ, dealing with a growing number of corporate taxation cases in situations involving the exercise of fundamental freedoms granted by the TFUE, came to safeguard the freedom of establishment and

[18] The relevance of transfer pricing within the European Union can be demonstrated by the correlation between the level of taxation on profits and the profitability of affiliated organizations. For example, in Germany, by analyzing the situation of the foreign corporations with subsidiaries, it can be found that an increase in corporate tax rate in the origin country by 10 percentage points triggers an increase on subsidiaries' profitability – artificially generated through transfer pricing – with a half percentage point. ALFONS WEICHENRIEDER, «Profit Shifting in the EU: evidence from Germany», in *CESifo Working Paper*, No. 2043, 2007, p. 21.

capital movement over the attempts of national tax authorities to protect their corporate tax bases.

Over the years, the ECJ doctrine has defended that exploring differences between tax systems does not contradict EU law. In light of this reasoning, the Court has never considered the risk of tax avoidance to be a justification for the existence of a tax disposition regarding the protection of tax revenues. In addition, it defended that the mere presence of a transnational element cannot presume, *per si*, tax avoidance. However, this ECJ's position has recently been shifting towards a higher protection of tax revenue interests of the EU member states. It can be said that the result of the ECJ case law and the EU law framework, limiting the discretion in relation to taxation issues, is the "price to pay for integration". This race to the top of anti-avoidance measures has also occurred in the US, with the codification of anti-avoidance rules.

3.2. *Problems Related to the Application of Transfer Pricing Especially When Assessing the ALP*

When facing transfer pricing, it must bear in mind the presence of three conflicting interests at stake, namely, the interest of the group to maximize its income, the interest of the states with the higher tax burden to not lose tax revenues and the interest of the states with lower tax pressure to attract the investment of MNEs. The societies, companies and markets have become increasingly more integrated, not only through the formation of regional markets but also through globalization in general. Thus, it seems difficult to find comparable transactions among independent enterprises, especially since such transactions are confidential and not easily revealed either to the tax authorities or to its competitors.

However, the business economics of the multinational firms do grant taxpayers strong reasons to use transfer prices that divert from those engaged by independent parties. Therefore, the assumption that normal group transfers usually match transfer prices among independent parties in the open market can easily be rebutted, and tax authorities must be aware of their potential misuse.

Therefore, the application of the arm's length principle requires a great amount of data to establish the comparison between transactions and activities among related enterprises and between the transactions and activities of independent enterprises. Gathering this data is costly and time-consuming for both the tax administration and the taxpayers, especially if a significant number or type of cross border transactions are at stake.

Another problem that may arise relates to the uncertainty surrounding the ALP, something enterprises have to face whenever, for example, two countries compute different transfer prices for the same transaction[19].

Additionally, the products and services are becoming more specialized and less comparable; they are also becoming non-materialized and unknown. A significant portion of the relations among groups deals with intangibles (like patents, trademarks, know-how's, etc.), which are difficult to evaluate.

It can also be argued that the arm's length principle requires an independence that goes against the rationality of the groups. Indeed, the enterprises belonging to the same group are not independent of one another. From the group´s perspective, it is often difficult, if not impossible, to apply an "independent" price to an enterprise of the group. In fact, it is this aspect of multinational and national groups which grants a competitive advantage, in which they act in the market as a single entity and obtain more benefits, rather than operating under the arm's length principle. In this way, the groups' company acts as the organ of a unitary body, but there are some costs that do not exist outside of the related group companies. Therefore, it is often difficult to determine which part of the expenses can be allocated to each of the group companies. Therefore, the assumption that dependent parties of such multinational firms are required, by tax law, to behave as independent parties ignores the purpose of organizational economics. The

[19] Despite basing its international guidelines on the ALP, within the OECD framework, there is no expressed global definition of the arm's length principle nor is it applied uniformly. Notwithstanding the reference to "associated enterprises" in Article 9 of the Convention, this is often inadequate in the resolution of disputes arising from certain transactions since it requests the contracting states to attain an agreement on what is an acceptable arm's length price to be paid for the transfer. Furthermore, another key element of the article, namely the concept of "associated enterprises" is not expressly defined in the article aforementioned or in the Convention.

transfer pricing that occurs inside an integrated firm chasing business models largely diverges from the outcome that arises in the outside market operations.

Another shortcoming is related to e-commerce: the taxation of profits based on the physical presence in a certain jurisdiction becomes inadequate. To this extent, the criterion of the permanent establishment is inappropriate according to the possibilities that the e-commerce, the internet and the communications technology position papers provide to data transmission, online shopping, etc.

3.3. *Transfer Pricing in the European Union*

In the European Union (EU), taxation for MNEs is an important factor in their economic strategic decision when faced with the diversity of extremely different tax regimes among member states. Related to this diversity of tax systems, the prices established between associated enterprises situated in different Member States, namely the transfer pricing that are practiced, may create obstacles to the free functioning of the internal market and its four freedoms. Currently, under the twenty-eight different tax systems, the enterprises operating in different tax jurisdictions must determine their profits in each legal tax jurisdiction by applying the "arm's length principle".

This may raise complex issues regarding "transfer pricing" and significant costs in complying with taxes and accounting rules which vary from one member state to another. As a starting point, it is assumed that the different tax rates applicable to profits of the companies in the same "group" that perform a great number of activities in different member states can disrupt the internal market. On the other hand, the existence of different tax rate areas or privileged taxes regimes is responsible for international business competition that triggers loss of tax revenue by the member states.

Due to the increasing economic integration in the EU, it is practical to look at how other integrated economical areas like federal states, have addressed

transfer pricing issues and the questions concerning the attribution of profits between related enterprises[20]. *Does the general, economic, political and legal reasoning against the arm's length standard require the introduction of global or regional profit consolidation for corporate groups accompanied by a formula apportionment (FA) of the tax base*? Inspired by the U.S. example and even prior to the tax reform proposals by the European Commission (2001), McLure/Weiner[21] raised the question about whether a formula apportionment, which, alongside the SA, is another method for determining the geographic source of income, should be implemented in the EU. In fact, one option is to leave the "traditional" transfer pricing device and move towards a more realistic alternative such as consolidation or formula apportionment[22]. A great step taken in this direction in the European Union panorama was the European Commission draft directive on the Common Consolidated Corporate Tax basis (CCCTB)[23]/[24]. However, one must bear in mind that, although it could solve some problems that characterize SA/ALS, the FA also suffers from problems of its own.

3.4. *The Unitary Taxation Approach*

For many tax experts, the unitary approach makes more sense than the "SA", applicable under the ALP. In fact, even during the 1930s when the "separate entity" approach was first agreed upon internationally to deal with transfer pricing, it was recognized that in practice, national authorities should check the all firms to guarantee a fair split of the total profits allocated to affiliates. However, since the 1990's, there have been techniques created that work towards unitary taxation. The present international tax system deals with MNEs as if they

[20] The states of the United States that impose corporate income taxes and the provinces of Canada have long employed FA.

[21] CHARLES E. MCLURE JR. & JOANN M. WEINER, «Deciding whether the European Union should adopt formula apportionment of company income» , in *Taxing Capital Income in the European Union, Issues and Options for reform*, Oxford University Press, Oxford, 2000.

[22] *Idem*, p. 258.

[23] EUROPEAN COMMISSION, Proposal for a Council Directive on a Common Consolidated Corporate tax base (CCCTB), COM(2011) 121/4.

[24] It cannot be underestimated the political and the administrative problems of shifting to a new system.

were separate entities operating in different countries. This reflects weak coordination between tax authorities and allows the "separate accounting" approach a tremendous scope for MNEs to shift their profits around the globe to suit their tax affairs. The basis of the unitary method is that each MNE must prepare a combined report covering the entire corporate group engaged in a unitary business.

3.5. *Formulary Apportionment Method Concept (FA)*

The apportionment method rests on the difficulty of effectively attributing income by source. The theoretical background relies on the assumption that certain business elements accurately reflect the measures of the tax to be attributed to a particular state. Traditionally, the formula used in the US is the so called "Massachusetts Formula", where the elements are sales, payroll and assets (real and tangible personal property), weighed by state-specific incidence factors and averaged.

Under FA, the net income of corporations doing business in more than one country (or a group of related companies) is divided between the countries where the corporations (or group) operate.

The question that has persisted in the last decades in this context is whether this formula apportionment method used, for example, among the States in the US, can be an alternative to the arm's length principle within the European Union.

3.6. *The Arm's Length Principle vs a Formula Apportionment: Main Differences*

In fact, both methods reveal great differences between them[25] .

[25] In contrast to a tax system based on separate accounting and arm's length pricing, under formulary apportionment, companies do not attempt to calculate the income of the affiliated entities of the corporate group. Instead, the corporate group first combines (or, consolidates) the income of each of its operatives into a single measure of taxable income. The group then uses a formula to apportion the income to the various locations where the group conducts its business. This formula is generally the share based on of business activity in a location to the total business activity in all locations.

As we have seen, the ALP, originating from the US system, is deeply rooted in the European taxation way of reasoning in the case of intra group transactions on multiple levels: OECD's level, EU's level and the purely domestic level. The ultimate goal is to achieve an attribution of fair tax shares to different jurisdictions in cases where one part of an enterprise delivers goods, services or know-how's to another part of that same enterprise located in another country.

The FA method uses a predetermined formula to determine the geographic source of corporate taxable income, rather than using separate accounting. Therefore, by employing this formula, the tax liability does not concern the profits actually earned in a particular jurisdiction but the profits generated throughout the group of jurisdictions.

3.7. *Formulatory Apportionment as the Alternative to ALP?*

In fact, the application of the SA may be, in some cases, a better solution, depending on the industry at stake. The conceptual impossibility of applying the ALS must be recognized when facing some economic interdependence or whenever the goods or services are not transferred in a market transaction. In fact, whenever economic interdependence is at stake, FA could resolve some difficulties related to transfer pricing that contaminate SA/ALP; for example, when applied to corporate groups, FA could make tax havens ineffective. In fact, the ALP is criticized for its incapability of capturing the positive effect (meaning higher profits) due to the economies of scale and scope of large multinational enterprises. The larger the multinational enterprise, the higher the probability of less accurate income allocation based on transfer pricing.

4. The EU Approach to Formula Apportionment

In 1992, a report named the Ruding Report[26] was released, examining the question of whether a formula apportionment method could be an alternative to the arm's length principle concerning the taxable income from companies acting

[26] Report of the Committee of Independent Experts on Company Taxation, Commission of the European Communities, March, 1992.

within the community space. As revealed by the committee position, the apportionment method can be used as an option whenever a single country has a separate and local tax jurisdiction. At the time, the committee presented some disadvantages concerning the apportionment formula in the community. First, it can be argued that this requires a high level of integration, namely, a common currency, a common company law, common accounting standards and common experts in tax administrations. The second disadvantage: it might apportion profits to countries where they were not earned. Thirdly, this would imply that renegotiation of all tax treaties between member states and possibly with third countries is needed to change the arm's length method to a formula apportionment method. A fourth point: if the formula apportionment were used within the community space on one hand and the arm's length method was used outside the Community on the other hand, this could further complicate the resolution of double taxation disputes. In addition, this might trigger some problems whenever tax administrations need to apply two separate standards to a transaction involving more than one member state and a third country. Bearing this in mind, the committee concluded that a reconsideration of the arm's length method would not be desirable over formula apportionment in the future. This was justified by the need for higher level of integration among member states which, at the time, had not been achieved yet.

Nevertheless, the question of whether formulary apportionment could be a solution to the problems posed by transfer pricing persisted through the years. In fact, due to all the problems associated with the application of the ALP, the idea of adopting common corporate tax rules emerged in the European arena. Therefore, the Commission published a directive for a proposal of a Common Consolidated Corporate Tax Base.

The publication of these proposals by the Commission represents a landmark moment in the development of the international tax system[27]. This topic will be developed in the following sections.

[27] «European Commission issues proposals for taxation of digitalized economy», EY Global Tax Alert Library, p. 5, available on *http://www.ey.com/Publication/vwLUAssets/European_Commission_issues_proposals_for_taxation_of_digitalized_activity/$FILE/2018G_01649181Gbl_EC%20issues%20proposals%20for%20taxation%20of%20digitalized%20activity.pdf.*

PART III

5. Transfer Pricing after BEPS

In October 2015, the OECD, with the political support of the G20, presented a series of reports in their project on Base Erosion and Profit Shifting (hereinafter BEPS).The BEPS proposal appears as a result of this call for action in the fight against the tax base erosion and diversion of profits to low taxation jurisdictions. The BEPS project anticipates the end of the *laissez-faire* era and the beginning of the new era of state intervention, by raising the standards of best practices to be implemented by the companies in the scope of their activities.

Of course, given that transfer pricing is usually used by MNEs for the purpose of tax avoidance, it constitutes a significant topic in those reports. The OECD Transfer Pricing Guidelines are relevant worldwide as they are applied even by non-OECD countries[28]. The final report on BEPS is a revision of the OECD Transfer Pricing Guidelines introducing a new coordinated approach to transfer pricing rules[29]/[30].

In fact, it has been outlined several times that the major shortcoming in the existing tax rules is the reliance on the separate entity approach *(i.e.*, each country taking those parts of the MNEs within its jurisdiction as if they were independent enterprises) and on the arm's length principle. However, with BEPS, a new approach has been introduced. According to this new system, MNEs would be treated as single firms in accordance with the economic reality that they operate. In other words, the direct link between a company's actual presence in a country and its effective contribution is ensured through taxes towards the collective service and infrastructure that facilitates that activity. In sum, in light of this new principle, MNEs are taxed "*where economic activities*" and "*valued is created*".

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[28] For instance, Nigeria, Tanzania and Kenya.

[29] JOE ANDRUS & PAUL OOSTERHUIS, *Transfer Pricing after BEPS: Where are we and where we should be going*, March 2017, p. 89.

[30] In fact, the final report on BEPS Action 13, titled *Transfer Pricing Documentation and Country-by-Country Reporting* rewrote Chapter V of the OECD Guidelines.

In fact, the reform of international tax rules established by BEPS can be defined by this overarching objective: the alignment of profits/tax with real economic activity (place of value creation) [31]. This "*moving towards a unitary approach*" (initiated 15 years ago, designed in 2013 with the CCCTB, revisited in the G20 world's leaders meeting and echoed in the BEPS project published in October 2015) is a result of the commitment of the countries' representatives to focus attention on three transfer pricing problems that were thought to trigger the separation of income from relevant economic activity.

As previously mentioned, transfer pricing elements play an important role in the G20/OECD achievement of this goal, along with other BEPS project reports that also adopted a unitary taxation approach (especially on the apportionment of costs). For transfer pricing in particular, the 2015 BEPS project introduced new transfer pricing documentation requirements for the companies and also established a global country-by-country template report that large MNEs must prepare and submit annually to disclose the details of their income, taxes due and paid and employees in each country. Through this, the tax authorities of each country have an overview of the largest MNEs worldwide by accessing economic activities indicators of certain MNEs. This is considered to be one of the major achievements of the BEPS project[32].

However, despite foreseeing some of the measures that ultimately contributed to the establishment of the *unitary principle*[33], some outlined that this could

[31] JOE ANDRUS & PAUL OOSTERHUIS, *Transfer Pricing after BEPS: Where are we and where we should be going*, March 2017, p. 89.

[32] TOMMASO FACCION & SOL PICCIOTTO with comments and contributions from ANNE BROCKMEYER, KIMBERLY CLAUSING, MICHAEL DUST, CLIFF FLEMING, DAVID S. MILLER & DANUSE NERUDOVA, *Alternatives to the Separate Entity/Arm's Length Principle for Taxation of Multinational Enterprises*, Independent Commission for the Reform of International Corporate Taxation (ICRICT), September 2017, p. 5.

[33] The "unitary taxation" concept is many times mixed with the "formulary apportionment" which might lead to misunderstandings. In fact, several alternative methods giving transnational corporate groups a unitary group treatment are available as many approaches have been implemented to move towards a unitary approach. Reference is made to the residence-based worldwide taxation (RBWT); destination-based corporate tax; unitary taxation with formulary apportionment. These options do necessarily mean that they have to be adopted unilaterally and exclusively, as they can be combined in a coordinated approach. For instance, the adoption of the CCCTB within the EU would entail formulary apportionment among the participating states but could be overlapped with a form

have been counterbalanced by reinforcing some points of the *separate entity* approach. Reference is made specifically to the exclusion of the formulary apportionment consideration on the profits where abandoning the independent entity principle was met with greatest reluctance. In fact, under the BEPS proposal, the departure point for the attribution of profits is still the transfer pricing rules. This means that it still relies on the independent entity principle and transactional analysis or, in other words, in the various entities in the MNE group and the transactions between them[34].

In fact, there are 15 BEPS Actions addressing the transfer pricing and their reports have resulted in a substantial rewriting of the OECD Transfer Pricing Guidelines, extending them from 370 to 600 pages. However, despite being redesigned, they still take the various entities of the MNEs and the transactions between them as a point of departure.

Despite the above, there is undoubtedly a significant reorientation of the rules, with focus on the accurate consideration of the facts and circumstances of each business to properly assess the true nature of these transactions. Evidently, this requires a broad understanding of the industry sector in which the MNE group operates (its business strategies, markets, and products, its supply chain and the key functions performed, material assets used and important risks assumed). Only based on such an analysis will a tax authority be able to characterize, or in even some circumstances, disregard, the ostensive terms of the related party transactions.

In sum, the BEPS project could enforce the powers of the national tax administrations, but they could also involve a more stringent application of the rules, where considerable increase of the rule complexity will be applied. Evidently, the tax experts engaged in the BEPS projects could not agree on clear criteria or principles to decide how to allocate profits based on how value is created.

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of RBWT towards the rest. Another example: RBWT could be applied using the formulary apportionment in place of source and transfer pricing rules to distinguish income that carries foreign tax credits from income that does not – *idem*, p. 15.

[34] TOMMASO FACCION & SOL PICCIOTTO with comments and contributions from ANNE BROCKMEYER, KIMBERLY CLAUSING, MICHAEL DUST, CLIFF FLEMING, DAVID S. MILLER & DANUSE NERUDOVA, *Alternatives to the Separate Entity/Arm's Length Principle for Taxation of Multinational Enterprises*, *cit.*, p. 1.

At the same time, this continues to incentivize the MNE to create complex structures by splitting up functions and efficiently attributing the tax risks. Nevertheless, this key issue will receive further attention, both through an analysis of the profits split method and the digitized economy. As mentioned, these issues involve considerations of the MNE as a unitary firm.

6. The CCCTB Proposed Scheme

The CCCTB is the result of a Proposal from the European Commission, dated from March 16th, 2011, released with the main purpose of tackling some major fiscal impediments to growth in the single market[35].

On a *prima facie* analysis, this European apportionment mechanism is an ambitious project that uses a complex, yet flexible sharing formula. Although, this is not a Commission innovation since it fully uses the experience of the non-European tax legislations providing for formulary apportionment such as Canada and the United States. In this sense, one of the most sensitive topics the European Commission had to address in the development of the CCCTB was the uniform apportionment formula. One lesson that can be taken from US experience is that more uniformity is recommended for a European system of FA.

6.1. *Key Concepts*

The operational profile of the CCCTB is based on three important concepts: the "*one stop shop*" (which means that the taxpayer is in contact with only one tax administration throughout the entire process), *the principal taxpayer* (it would normally be the parent company if the resident is a member state, which will be under the obligation of ensuring relevant administrative requirements) and *the principal tax authority* (which will be the tax administration of a member state where the principal taxpayer is a resident for tax purposes – in the case of non-EU resident taxpayer, the principal tax authority will pay the administration tax for the location of a permanent establishment).

[35] See the Explanatory memorandum to the Proposal, paragraph 4.

However, the main concept introduced by the CCCTB is the "sharing mechanism" – a mechanism which has many similarities to the formulary apportionment[36] but constitutes a *sui generis* apportionment mechanism. Firstly, although this sharing mechanism is rather complex, it is flexible[37] enough to be adapted to specific situations or avoided in other circumstances.

The idea behind the sharing mechanism is that companies should pay taxes in proportion to their economic presence in a country. In this light, the need to employ a sharing formula to allocate the common tax base between the members of a cross border group appears as a natural consequence of the consolidation, which will entail the elimination of the transfer pricing issues from the European arena.

Under the CCCTB, once the company's tax base is determined, it will then be shared with all member states where the company is active based on a fixed apportionment formula. The Commission's decision for a distribution formula is based on economic factors: on the supply side, the labour and capital, and on the demand side, the sales[38]. These three factors indicate that the formula draws on readily available data, will be difficult to manipulate and will be representative of where profit is really generated in a business. The CCCTB is not about tax rates

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[36] Various possibilities for sharing have been considered by Commission Services, varying from macro-based apportionment based on factors such as gross domestic product or national VAT basis to micro-based apportionment. Reference documents such as Working Paper 47 dated 17 November 2006 (The mechanism for sharing the CCCTB), Working Paper 52 dated 27 February 2007 (An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB), paragraph III of Working Paper 55 dated 28 June 2007 (Summary record of the meeting of the CCCTB Working group) and Working Paper 60 dated 13 November 2007 (CCCTB: Possible elements of the sharing mechanism) reflect the extensive discussions on the complexities and challenges linked to the various apportionment mechanism systems that could have been adopted. In fact, the Commission Services founded its analysis on *The Taxation Paper (*written by AGÚNDEZ-GARCÍA) and analyzing in particular the two main types of apportionment mechanisms: a macro-based apportionment and the micro-based apportionment mechanisms with both the traditional formulary apportionment and the Value Added approach.

[37] By default, the general principle based on three elements – sales, labour and assets – shall apply. In the second stage, a certain degree of flexibility regards the application of specific rules to particular sectors of activity. Thirdly, a second degree of flexibility is introduced due to the safeguard clause, allowing the application of another sharing method, in case the apportionment mechanism institutes come across as insufficient.

[38] Article 86 of the Directive.

but rather about the transformation, through apportionment, of the corporate income tax into direct tax under specific factors.

6.2. *Some Controversial Issues Related to the Application of the CCCTB*[39]

Nonetheless, there is a wide array of practical concerns that can be brought up in consequence of an effective application of the CCCTB[40].

One main issue regards the omission of intangibles from the asset factor which, generally speaking, can discourage innovation; these kinds of assets are the key drivers of the enterprises, so not including them goes against the EC policy. One main limitation of the proposal is related to the consolidated accounts that need to be filed. Since they only have to include the members of the corporate group residing in participating states, they are able to deprive the CCCTB of a key advantage of the unitary approach by allowing MNEs to exclude, their accounts, which are the intermediary agents.

Another shortcoming is related to the fairness of the formula. An analysis of the proposal shows that different states will benefit from different levels of advantages from the CCCTB depending on how the allocation is determined. In this sense, there is a high probability that the proposed apportionment will benefit the states where there is more staff, higher density and a large amount of its production. Furthermore, the "fairness" of the introduction of the sales factor in the formula is questionable. In fact, this inclusion may bring great advantages for the countries with large markets. In this light, the allocation of taxing right to the

[39] For a deeper analysis of the topic, see L. CERIOENI, «The Commission's Proposal for a CCCTB Directive: Analysis and Comment», in *Bulletin for International Taxation*, IBFD, September 2011, pp. 527 and ff.

[40] It must be noted that, in the end of 2011 and in the beginning of 2012, the discussion around the CCCTB has intensified and therefore, at the present moment, there are a lot of alteration proposals which, if approved, are able to significantly modify the document base – the Proposal of 2011. One of the main alteration proposals, released in March 2012, is related to the reparation key of the tax base initially; the formula was based on equitable repartition (1/3) of each factor, namely the sales, the labour and the assets. The new proposal gives less weight to the factor sales (passing from 33,33% to 10%) and, therefore, the weight of the other factors is enhanced to 45%. This alteration, if implemented, has substantial importance.

source state can also be jeopardized by idea of the "sales by destination" (Article 96).

In the same sense, labour might be affected as this may create a higher tax burden in jurisdictions with superior wage levels.

Another difficulty regards the estimated loss of revenue and the simultaneous existence of two parallel systems due to the non-binding nature of the CCCTB. For the member states, the introduction of an optional system will force tax administrations to manage two distinct tax schemes (the CCCTB and their national corporate income tax).

Another reservation worth mentioning is related to the cooperation among tax authorities that FA requires. In fact, FA is based on a strong cooperative approach, demanding information obtained from all parts of the unitary business in different geographical areas. In this way, under FA tax, evasion can only be avoided if the tax authorities of all the jurisdictions involved are able to check the total amount of income reported and the value of the factor in each country.

Furthermore, a real problem may arise from the difficulty of calculating the allocated tax base, with the associated risk of tax planning. Additionally, there is not a precise assessment of the source of origin of the income, which is difficult to determine considering the prevention of tax avoidance.

Under the proposal framework, the compensation of losses within the same group is automatically considered and, therefore, some situations of great complexity can be overcome. In this respect, we can take as examples, the communication issues, the transfer of losses among companies of the same group or between branches, and the company's multinational accounting. However, this can contradict the internal market by creating some situations that lead investments only to big countries by allowing more opportunities for loss deduction from a wider tax base.

A great merit that can be attributed to the CCCTB proposal is that it will, owing to FA, permit the evacuation of European transfer pricing issues, making transfer prices unnecessary in inter-company transactions. In fact, the group's total profit is determined by the level of its parent's profit. Hence, transfer pricing would no longer be necessary for EU transactions. The non-application of the independence principle within the same or between different groups of societies

and their branches allows the elimination of tax avoidance, often achieved through the exploitation of this principle. The current complexities of interpretation and application of the OECD guidelines on transfer pricing cease to exist for EU activities. The consolidation of the tax base will determine the taxable income for the group of companies. In short, the transaction price will have no influence on corporate income tax paid by companies. Double taxation due to conflicting qualifications would no longer arise for EU transactions as well.

According to the FA method, a company is taxed by evaluating its total income; therefore, it is not able to shift its income from one location or subsidiary to another. Nonetheless, it can relocate the origin of its sales or modify the values of its property and payroll factors to shift its factors (for instance, by contracting independent agents in lower tax areas). Accordingly, a diversion of the production allocation factors might trigger great tax saving for the enterprise. For instance, the shift of the labour factor might trigger loss of tax revenues for the countries with a high corporate tax base. In brief, whenever the enterprise location and the transfer of business function into low tax base countries is decided for tax saving, this will negatively impact the domestic market, which might be concerned with losing its position as production sites. In this sense, it can be oppositely argued that transfer pricing problems are replaced by allocation problems.

7. The CCCTB Proposed Scheme: Recent Developments

Unsurprisingly, the 2011 proposals did not progress as the member states were not keen on adapting their domestic tax regimes. However, despite the failure of the previous attempts by the European Commission to introduce the CCCTB (due to several obstacles, but the tax consolidation being one of the more intractable debates), the Commission continued to defend the adoption of the CCCTB as the next step towards harmony in the fight against base erosion and profit shifting (BEPS).

As such, in 2016, the Commission backed the policy established in the 2011 plan and re-launched the common consolidated corporate tax base (CCCTB)

project in a two-step approach that included the publication of two new interconnected proposals on a *common corporate tax base* (CCTB) and a *common consolidated corporate tax base* (CCCTB). In brief, the two-step approach consists of the following:

• Step One [Common Corporate Tax Base (CCTB)]: Large multinational groups with global sales of at least EUR 750 million would be subject to a single set of rules to calculate their taxable profits in the EU (rather than calculating profits based on the rules under their national tax systems). For the companies falling below the threshold, this regime will be made voluntarily;

• Step Two (CCCTB): Following the adoption of the CCTB, the CCCTB would introduce rules for consolidation, formulary apportionment and a "*one-stop-shop*" for tax administration. Losses in one EU member state would be available to offset profits in another member state.

The intention is that the proposed CCTB is a step towards reestablishing the link between taxation and the place where profits are made, via an apportionment formula to be introduced through the new CCCTB proposal. The proposal includes several anti-tax avoidance measures, which only concerns the corporate tax base and is not intended to harmonize the national corporate tax rates (as the right to set their own tax rates will remain under the sovereignty of each member state).

Finally, on 15 March 2018, the European Parliament (EP) approved the two directive proposals for the CCTB and the CCCTB, supporting the need for the two directives to be implemented simultaneously. This creates the legal framework through which companies would be taxed in the European Union (EU) under a harmonized corporate tax law system that also takes into account their digital activities[41].

[41] The Commission's proposals focus on a two-phased approach: an interim solution, referred to as the Digital Services Tax (The DST or DST proposal) and a longer term *Council Directive laying down rules relating to the corporate taxation of a significant digital presence* (SDP or the Significant Digital Presence proposal). This proposal would enable member states to tax profits that are generated in their territory, even if a company does not have a *physical* presence there. The new rules would ensure that online businesses contribute to public finances at the same level as traditional 'brick-and-mortar' companies in Fair Taxation of the Digital Economy, available at *https://ec.europa. eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en*.

In the form adopted by the EP, the introduction of the rebranded CCCTB would be gradually implemented as member states implement the BEPS proposals. The new rules would be mandatory for parent companies or qualifying subsidiaries incorporated in a member state that belong to consolidated groups with total revenues exceeding EUR 750 million during the previous financial year. Entities would need to be in one of the prescribed legal forms and be subjected to one of the prescribed corporate taxes. Permanent establishments (PEs) situated within the EU would also be subjected to the rules. Entities incorporated outside the EU in an equivalent legal form (to be established by the EC on an annual basis) would be subjected to the rules with respect to their EU PEs, according to the threshold. A company belonging to a consolidated group with revenues below the threshold would be allowed to opt into the CCTB (and CCCTB) regimes for a minimum five-year period.

The two directive proposals mention the deadline of 31 December 2019 for transposing their provisions, with measures to take effect as of 1 January 2020. Groups of companies will calculate their taxes by consolidating the revenues of their constituent companies across all EU member states, with those taxes shared between member states according to where the profit was generated (based on the four allocation factors – labour, assets, sales and data – collected and exploited by digital content users).

Many member states, including smaller economies reliant on competitive tax regimes to attract inward investment, however, are not in favor of a common tax base.

Formulary apportionment was rejected at the outset of the G20/OECD BEPS project (which includes 21 EU member states), and its adoption would leave the EU out of step with the international consensus. The exclusion of intangible assets ignores one of the major drivers of modern business: numbers of people and tangible assets are not necessarily good proxies. Small economies with fewer customers are likely to lose out to larger economies on the destination sales factor. The interaction of the proposed rules with those of non-EU countries is

also unclear. In sum, the proposals still do not provide the answers to many important technical questions, which would still require considerable work before any common tax base is implemented.

Concluding Remarks

The protection of national tax revenue is a central issue for the financial policy of all member states, especially for those with a high level of taxation. Under these premises, the adoption of a common consolidated corporate tax base in the European Union can be used, on one hand, as an important device to limit the migration of tax base among countries through transfer pricing and, on the other hand, as a tool for increasing the efficiency of the corporate income tax through the simplification of the operations concerning corporations' profit declarations. Its real impact on member states and MNEs will only become clear once applied. Furthermore, as it deviates from the widely recognized ALP, it is probable that its application will cause great anxiety.

Despite its limitation, the CCCTB is important because it provides a complete proposal for a unitary state system that will help ALP in the transition to unitary taxation. Despite the OECD's insistence that the ALP is the only accepting principle, it can also benefit from the considerable support of the U.S. for a unitary approach.

Summing up, it must be said that a perfect tax device must achieve one main goal: the balance between equity and efficiency. This is, undoubtedly, a difficult task since taxation, namely international taxation, involves complex cross border transactions and political decisions which often must weigh pure economic efficiency and national interest. Nevertheless, neither CCCTB nor the arm´s length principle achieves this perfect equilibrium since both have their pros and cons. In fact, the arm's length principle does not provide a uniform solution to transfer pricing and, therefore, the CCCTB would probably be more suitable to a region such as the EU. Essentially, formula apportionment works like a tax on each of the factors included in the formula. Since the Commission does not want to question the member states' right to set the tax rate, there is still room for tax competition via tax rates. Due to the common tax base across the

EU, it is no longer possible for member states to compensate high tax rates with a narrow tax base or vice versa.

Despite its rigidity, its potential to engender unpredicted administrative costs along with the fact that it is not totally immune to strategic tax planning[42], make the CCCTB a possible effective solution to the problem of international corporate tax planning within the EU. In particular, the CCCTB eliminates the incentive to shift profits to low tax countries via transfer pricing or financing. However, the existing problems of the arm's length principle continue to exist with respect to third world countries, and there is still room for tax competition between member states as long as the tax rates are not harmonised within the EU.

Despite the establishment of the internal market and of the economic and monetary union, the allocation of resources and the distribution of economic activities as well as investment choices are still affected by the enduring tax barriers. These barriers have become increasingly significant, whereas other obstacles to the operation of the internal market have been removed. Under the arm's length principle, companies cannot generally consolidate profits earned in some member states with losses incurred in others. Consequently, this results in taxation problems (when cross border activities create liabilities that would not have occurred in a purely domestic context), like double taxation (when the same income is taxed in more than one jurisdiction) and transfer pricing disputes within the EU, coupled with the high costs of compliance with transfer pricing formality requirements. In the final analysis, this works as disincentives for investments in the EU.

In this way, the general solution set by the Commission seems to be a suitable long-term strategy to achieve the priorities set in Europe for 2020[43]. In fact, granting the EU businesses the possibility of opting for a unique common consolidated tax base method for determining the tax payable of their profits on an

[42] SPENGEL & WENDT, *A Common Consolidated Corporate Tax Base for Multinational Companies in the European Union: some issues and option*, Oxford University Centre for Business Taxation, 2007.

[43] CHRISTOPH SPENGEL, M.ARTINA ORTMANN-BABEL, BENEDIKT ZINN & SEBASTIAN MATENAER , «A Common Consolidated Corporate Tax Base for Europe: an Impact Assessment of the Draft Council Directive on a CC(C)TB», in *ZEW Discussion Papers (Centre for European Economic Research)*, No. 12-039, June 2012, p. 2.

EU world-wide basis (instead of having to apply 28 different national tax systems) appears as a good plan for success in the "smart, sustainable and inclusive growth of the EU".

This moving towards tax neutrality – between national and cross border activities – performed by the European Union will grant the enterprises more benefits of the potentialities of the internal market.

The answer to the question: "*is this the right time for A CCCTB under the actual framework of the transfer pricing within the European Union and where does it lead us?*" does not have a clear answer. The CCCTB is in the order of the day and lays an important role on the EU agenda as a great contributor to the realization of the European internal market, especially in the support granted to the European economic integration and to the stability of the Eurozone.

The main problems associated to this are not only the technical aspects of the arm's length standard, but also the political and conceptual implications that influence this. Nevertheless, the system has never worked efficiently even after being in use for several decades, since it is plagued by several operational and conceptual shortcomings.

As some states remain skeptical about the adoption of these provisions, it is difficult to assess whether a consensus will be reached at this time.

International Tax Planning and its Impact on Inter-Juridical Tax Competition of EU and OECD Member States: The Specific Case of Hybrid Mismatch Arrangements

Tilmar W. Goos *

1. Introduction

This research topic addresses the impact of international tax planning on inter-juridical tax competition of EU and OECD Member States through the specific example of "hybrid mismatch arrangements", hereinafter referred to as "HMA". This means mismatches arising from the different treatment of an entity, financial instrument or transfer. Business executives, lawyers and accountants are increasingly faced with problems which require a measure of international tax planning. It is both lawful and sensible to arrange one's business affairs in a way that attracts the lowest possible exposure to tax. The widening scope, complexity and provisions of tax laws make it more crucial than ever for businesses to carefully and consciously plan their taxable events. However, whilst these tax base eroding schemes are technically legal, their effect is to lower the corporate tax bill, contrary to the intentions of domestic government policy. Developing countries, in particular, face formidable challenges in attempting to establish efficient tax systems[1]. This is due to the way the primary sector employs the majority of workers, who are seldom reimbursed regular wages, and when they are, it is mostly in cash. Moreover, because workers generally do not consume in highly sophisticated stores, this duly administers fi-

* LL.M, Ph.D. Researcher 2018-2021at University of Minho, Braga, Portugal.

[1] V. TANZI & H. ZEE, *Tax Policy for Developing Countries*, IMF, 2001.

nancial records according to GAAP[2] standards. Consequently, the lack of money leads to an absence of qualified experts in the field of tax administration, thereby causing difficulties in creating an efficient tax administration.

2. Types of Hybrid Mismatch Arrangements

2.1. *Hybrid Entities: Transparency vs. Opacity*

The allocation of income is of critical importance in tax law. Therefore, tax laws of a country often contain rules about how certain domestic entities are treated in terms of taxation. When income in a state is earned, that state, often referred to as the source state, has to determine the taxable subject. It, therefore, needs to determine whether a foreign non-resident entity is subject to company taxation in that state. Generally, it needs to answer the question of what determines an entity and what requires a distinction between residents and non-residents[3].

A Partnership is a form of entity which is an arrangement of two or more individuals for the purpose of sharing profits and liabilities of the business venture and can be utilized as a cross-border investment or business instrument. The classification of this type of arrangement is usually defined by domestic law. Sometimes, it may be that this treatment question must be determined by a foreign legal system. A variety of arrangements are available, whether all partners share the profits and liabilities equally or some partners have limited liability. In addition, not every partner is necessarily involved in the management or the day-to-day business operation of that venture. From a tax perspective, partnerships create challenges and opportunities because their legal definitions differ greatly across jurisdictions. Consequently, they end up being treated much more favourably vis-a-vis taxes compared to corporations and are considered to be the least harmonized.

[2] Generally accepted accounting principles (GAAP) are a common set of accounting principles, standards and procedures that companies must follow when they compile their financial statements.

[3] See ECJ, 11th October 2007, Case C-443/06), Hollmann v. Fazenda Pública.

Under common law, partnerships are not considered to be a legal entity, whereas under civil law, they are usually treated as a separate legal entity. They can be taxed in two different ways, either as a separate legal entity or as a fiscally transparent entity. Under the former approach, the entity itself would be subject to tax on its income. It then is treated similarly to a corporation being taxed on its income. Partnerships that are taxed as separate entities can also be called opaque or non-transparent, which mainly depends on domestic law. Under the latter, the entity itself would not be liable to tax as the income of the partnership is subject to tax at the level of its members (i.e. partners) forming the partnership. When the income of a partnership is taxed at the level of its partners, it is considered to be a transparent entity and can also be called a "flow through entity". A hybrid entity is created when a firm is organized on the one hand as opaque, a separate taxable person like a corporation under the tax jurisdiction of one country, while qualifying on the other hand as a transparent partnership entity in another country[4], which would result in significant tax savings. The consequences of these qualifications are significant. The recognition of whether an entity is considered opaque or transparent for tax purposes by a tax authority involving cross border arrangements may lead to a conflict in the allocation of income, irrespective of their status as a legal entity. In other words, in a situation where the status as a taxable person is not exactly clear, the questions of to whom the income is attributable and in which state arise. Hence, problems occur if two contracting states allocate income differently, which can lead to international double taxation as well as international double non-taxation[5].

2.2. *Dual Residency: Resident vs. Non-Resident*

MNE's often try to achieve tax breaks by establishing subsidiaries in low-tax jurisdictions, aiming to ensure the benefits resulting from ITP. Considering the investors' perspective, the reason for this is fairly simple. An investor looks

[4] IBFD, *International Tax Glossary*, 2009, p. 222.

[5] R. RUSSO, «The OECD approach to partnerships – some critical remarks», *European Taxation*, 43 (4), 2003, p. 478.

for value and return on his/her investment. States, on the other hand, aim to keep their sovereign rights to levy taxes. This section focuses on taxation rights and how a tax resident is determined.

Consequently, from a state's perspective, it is of utmost importance to determine its right to tax an entity and its activity in the territory in question. Due to the variety of definitions of residence, unless domestic legislation includes a tie breaker rule, a company might be considered a resident of more than one jurisdiction. Such a rule generally tests an entity in a five step approach, resolving the case of multiple residency to avail itself of relevant tax treaty benefits. It determines how the two states should treat the taxpayer's state of residency. Most countries apply the concept of territoriality[6] to enforce taxation rights. This means that liability to tax mainly depends on two factors: first, the existence of connecting factors in that territory, or a nexus between the jurisdiction which seeks to tax an entity on a worldwide basis (residence principle) and secondly, the activity itself, a taxable event, namely an income generating activity or asset located in that jurisdiction (source principle). International tax literature defines nexus as some definite link, some minimum connection between the state and the entity operating in its territory. A nexus establishes a relationship between the tax jurisdiction and a taxable person and is an instrument through which the right to tax is conferred. Taxation of MNEs depends on a variety of factors[7]. The most important concepts regarding the determination of residency are easily the place of incorporation, the place of effective management and control (POEM), permanent establishment (PE) and the beneficial ownership. Different countries use different concepts. These criteria determine the taxable event and have tremendous impact on (i) the overall liability to tax of an entity and (ii) how the taxable base is computed where CIT applies. Therefore, it can be said that *lex fori* (laws of a forum) of a sovereign state or the applicable tax treaty must contain a definition of connecting factors to answer the question of nexus to rightfully collect tax inside the state's territory because it cannot go beyond these boundaries. This could exemplify an enterprise that is incorporated in one

[6] R. RUSSO, *Fundamentals of International Tax Planning*, Amsterdam, IBFD, 2007, pp. 6-8.
[7] *Ibid*.

country but executes its contract in another jurisdiction, e.g. a sale of goods takes place in country and its POEM takes place in another third country.

Initially, the place of incorporation is used to test fiscal residency in many countries (e.g. Australia, Canada, the Netherlands, the UK and the U.S.). This principle is based on the incorporation doctrine and determines if a company is liable to tax in the state in which it is incorporated. If an enterprise is registered in a state, the connecting factor[8] remains constant, irrespective if it is actually managed in that state. In that way, dual residence conflicts may be solved where incorporation prevails. Nonetheless, it is often argued that the mere reliance on this principle gives rise to fraud because the incorporation of 'post box company' does not have any further connection with that state in which it is located. An important characteristic under this doctrine is that the company owner can choose where the firm is registered[9]. This phenomenon, however, may lead to what scholars consider the 'race to the bottom', a socio-economic phrase used to describe government deregulation of the business environment, or reduction in tax rates, to attract or retain economic activity in their jurisdictions.

From an international tax planning perspective, this criterion is often challenged to minimize the taxable base. Different states apply different criteria, which most likely results in situations where an enterprise is resident of more than one state for tax purposes. This situation is commonly referred to as dual residency. If, for instance, a jurisdiction considers the incorporation as the main criterion for taxation, but the other State uses effective management as a criterion, the company would then be resident in both States for tax purposes. Even in the case of non-residency, some states levy taxes on businesses that have a presence in their territory. In case that a presence is deemed to exist in a territory, the taxing rights are then based on the economic or jurisdictional involvement in that jurisdiction[10]. If the taxable activity as a connection factor is not sufficiently significant, the business activity of the non-resident is not liable to tax on

[8] B. SPITZ, *International Tax Planning*, London, Butterworth & Co., 1983.

[9] L. COLLINS, *Dicey and Morris on the Conflict of Laws*, Bd. 13th Edition, London, Sweet & Maxwell, 2000; B. R. CHEFFINS, *Company Law – Theory Structure and Operation*, Oxford, Clarendon Press, 1997.

[10] See Colquhoun v. Brooks 2 TC 490; Egyptian Hotels v. Mitchell 6 TC 152.

the activity in that country. If, however, domestic law recognizes the activity to be sufficiently significant, a connection factor is deemed to exist and tax liability arises from that activity. Some jurisdictions go so far as to tax all the profits of an enterprise in their territory regardless of how small the part of their taxable activity is in that state (source principle). Conversely, other countries regard profits as taxable only if they are derived from a PE[11] situated in that state. This rule stipulates that profits of a business's activities are only taxed by a state if there is a proven existence of sufficient nexus between the taxing state and the profit-generating state. In that way, a PE shifts the taxation right to that other state. Consequently, where there are insufficient or loose nexuses, taxation rights remain in the state of residence. Therefore, under the OECD- MTC, PE is the decisive condition for taxation of income.

The third important consideration when it comes to the imposition of taxing rights is the beneficial ownership. The concept forms one of the conditions to be met to determine tax charge or tax relief. Persons not entitled to tax treaty protection should be prevented from interposing entities with the aim of exploiting treaty benefits. This technique is known as treaty shopping. It often uses intermediary companies situated in countries with low or non-existent domestic withholding tax on dividends, interest and royalties, or a favourable treaty network. In this way, dividends, interest and royalties are channeled through these jurisdictions to enjoy withholding tax reductions, or exemptions, that would not normally be available in the absence of the intermediary company. Common law and civil law countries differ greatly in their definition of beneficial ownership. The concept originates from common law countries; therefore, in those jurisdictions the definition is more obvious and usually incorporated in domestic legislation. Common law countries differentiate between legal ownership, which implies that the owner has the discretionary

[11] The OECD-MTC Article (5)1 defines permanent establishment as a *'fixed place of business through which the business of an enterprise is wholly or partly carried on'* the following elements must exist: *a place of business, geographically fixed, temporarily fixed, at the disposal of the enterprise, through which the business of an enterprise is wholly or partly carried on.* Para. 2 provides a list of examples, Para. 3 deals with issues regarding 'project permanent establishments'; Para. 4 addresses *de minimis exceptions*. Para. 5 and 6 define an *'agency permanent establishment'*; Para. 7 clarifies that a subsidiary does not constitute by itself a permanent establishment.

power over and economic ownership of an asset, meaning the owner also holds the rights to the benefits of an asset. Civil law countries, on the other hand, do not differentiate between both notions and therefore, cannot rely on a guiding legal determination regarding this concept. This creates difficulties in situations that involve a practical interpretation of the beneficial owner concept[12]. The domestic law of a specific country may or may not provide clarity between the concepts and, therefore, should be addressed on a country-by-country basis because no general internationally accepted definition exists.

2.3. *Hybrid Instruments: Equity and Dividend vs. Debt and Interest*

A major goal for an enterprise is growth and expansion. As this requires money, it needs to explore a panoply of financial resources to raise capital. This is often achieved through an acquisition of external finances in the form of equity or debt. From a tax law perspective, the strategy an enterprise applies to finance their business operations can have a significant impact on the corporate taxable base[13].

Equity financing essentially refers to the process of raising funds for business purposes through the sale of shares in an enterprise, which represents an ownership in that company, in exchange for an advanced payment per share. It also represents a level of control rights over the company depending on the percentage of shares held. In this way, the shareholder's return on investment depends on the growth and distribution of capital by the company. In other words, the investors' return on investment is variable since it depends on the company's overall performance. Debt financing, on the other hand, is generally regarded as a resource[14] and typically occurs when a firm raises capital for expenditures through a loan from a lender or a bank as well as through the sale of bonds, bills, and notes to individuals or institutional investors. In return, the money must be paid back within a previously stipulated period of time, with a

[12] OECD, Interpretation and application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention, Public Discussion Draft, Paris, 2011, pp. 18-19.

[13] R. A. SOMMERHALDER, «Approaches to Thin Capitalization», *European Taxation*, 1996, p. 82.

[14] See R. RUSSO, *Fundamentals of International Tax Planning*, *cit.*, p. 107.

promise that the interest on the debt will be repaid, while at the same time relinquishing no controlling rights over the entity.

The repayment of the loan or bonds is usually independent of the company's growth. Terms of the return on investment that the investor expects remain constant and bear no relationship to the financial status of the company. Furthermore, investors have a prior claim to the company's assets in the case of insolvency[15]. A large body of research concerning corporate finance argues that the trade-off between the cost and benefit of debt financing determines a firm's optimal capital structure. One prominent benefit of debt financing compared to equity financing relates to the tax deductibility of interest expenses for corporate income tax (CIT) purposes based on the idea that interest is the cost of doing business while returns on equity do not possess this feature. Interest on debt, which is considered an expense in many jurisdictions, is generally deductible from the taxable income of the taxpayer. In other words, it is only taxed once, usually before the taxable base is determined. That base is then multiplied with the domestic CIT rate to determine the ultimate tax liability of an enterprise. The return on equity, on the other hand, is taxed twice--once at the level of the distributing company and once at the level of the recipient of the distributed dividend.

A classic example is a parent company residing in one country holding shares in a subsidiary based in another country as well as shares in a company based in a third country, which is then used as the finance vehicle. The parent country and the second country apply burdensome tax rates whereas the third country has low interest rates. The parent company capitalizes the third company resident in a low tax jurisdiction, whereupon that company subsequently uses this equity to finance the company located in the other country. The interest on that loan results in tax deductible expenses in the other country and is taxed in the third low tax jurisdiction.

A hybrid instrument (or hybrid financial instrument) is a form of financing that is treated differently by two or more tax systems[16]. It is considered to be

[15] SCHÖN *ET AL.*, *Debt and Equity: What's the Difference? A Comparative View*, Max Plank Institute, 2009.

[16] See R. RUSSO, *Fundamentals of International Tax Planning*, *cit.*, p. 124.

an attractive tool for achieving a reduced tax outcome. For instance, his particular instrument combines the aforementioned characteristics of debt and equity. From an international tax optimization point of view, this instrument can be utilized as an effective vehicle for significant tax arbitration in terms of tax expense minimization. This is because it includes a financing arrangement that is subject to a different tax characterization in two or more jurisdictions such that payment made under this instrument may give rise to a mismatch in tax outcome. These characteristics of hybrid financial instruments make them extremely attractive tools for deployment in the pursuit of effectively reducing overall tax burdens. A typical example for this instrument is a debt and equity arrangement, which is viewed as debt in one jurisdiction and equity in the other jurisdiction. These payments give rise to deductible interest in one country and an exemption[17] of dividend taxes in the other jurisdiction.

2.4. *Hybrid Transfers: The Question of Ownership*

From time to time, it may be advantageous or even necessary to transfer assets to a foreign subsidiary. This can be made via transfer of shares or patent rights (which are owned by a company situated in the home country) to a subsidiary located in another country or vice versa. The transfer can be completed in the form of a lease agreement. This generally involves fixed assets, which one company (the lessee) ultimately requires to carry on business operations that are owned by another company (the lessor), allowing the lessee to use the asset in return for a periodic fee[18]. In other words, the lessor transfers the beneficial ownership to the lessee and consequently receives a leasing payment in return[19].

At the parent level, only the distributed dividends become exposed to a tax liability. However, if the exemption method on intercompany dividends

[17] A tax exemption is a form of tax relief whereby all or a part of the foreign sourced income is excluded from the taxable base due to the fact that such income is subject to be taxed in the foreign country; B. SPITZ, *International Tax Planning*, London, Butterworth & Co., 1983, p. 52.

[18] See R. RUSSO, *Fundamentals of International Tax Planning*, *cit.*, pp. 154-155.

[19] D. ENDRES *ET AL.*, «Case Studies on Cross-Border Tax Planning», *International Company Taxation and Tax Planning*, Aalphen a/d Rijn, Wolters & Kluwer, 2015, pp. 441-466.

applies or if a subsidiary retains the profits, the parent company is not taxed in the home country. On the other hand, if a transfer takes place from a subsidiary to a parent, the subsidiary country is not able to tax gains that would result from the sale of the asset in the case of a book value transfer of that asset. Therefore, many countries treat the transfer as a taxable event at the level of the parent or the subsidiary at its fair market value following special transfer provisions. It is often necessary to obtain consent from local authorities prior to the transfer because it usually triggers a variety of tax breaks on the sale of the transferred asset (e.g. accelerated tax depreciation by choosing highest tax depreciation rates when moving assets where they are tax depreciable). It can, in some circumstances, also trigger tax liability in the other country if the asset is registered there[20]. At this point, it is important to mention that these transactions must be made on an arm's length principle, which is an internationally accepted standard, to prevent arbitrary profit shifting between a group of companies. It ensures that the prices for a transferred asset among members are the same prices that would be charged if the companies were not related (transfer pricing). Different allocation regulations with regards to the tax treatment of lease agreements may lead to a so-called "double-dip effect", which triggers a depreciation for the lessor and the lessee. This can occur when two jurisdictions differ in their definition of beneficial ownership. With regards to categories under (i) the operating lease agreement, the lessor can claim tax depreciation while the income from the lease is classified as taxable income for the lessor. By contrast, the expenditure resulting from the lease is a deductible expense for the lessee. In the case of (ii) finance lease agreements, some jurisdictions tax the lease income based on legal ownership and allow a depreciation for tax purposes to the lessor initiating the lease (in France or Italy)[21]. Other jurisdictions base their right to collect taxes on the economic substance of the agreement and, because it is not complex enough, there are countries that do not classify either of the aforementioned agreements, and instead, simply merge both systems to enforce taxing rights. In many cases, this diversity leads to hybrid transfers and

[20] HORWATH & HORWATH INTERNATIONAL, «Transferring Assets to a Foreign Subsidiary», *International Tax Planners Manual*, Sydney, Tax and Business Law Publishers, 1975, p. 44.

[21] See D. ENDRES *ET AL.*, «Case Studies on Cross-Border Tax Planning», *cit.*, p. 367.

the motivation for MNE's to create a tax saving mechanism by playing off one tax jurisdiction against another, thereby inducing an arbitrage between these systems, which encourages HMA. To put things into perspective, the lessor jurisdiction bases its taxing rights on legal ownership whereas the other country, the country of residence where the lessee is based, sees the arrangement as a financial lease and bases its taxing rights on the economic factor. This would result in a situation where both lessor and lessee capitalize the leased asset in their respective accounts and claim a tax-deductible depreciation. Hybrid transfer schemes create this qualification conflict, which results from different tax law jurisdictions, and addresses the transfer of ownership of an asset, which is treated in one jurisdiction for tax purposes but in other jurisdictions for purposes other than tax.

3. Consequences of International Tax Planning and Inter-Juridical Tax Competition

Complex restructuring of business transactions and corporations facilitate a reduction in the effective tax liability, which has enormous consequences for all countries. In a world where globalization creates an integrated single world market, this facilitates companies to execute business operations beyond national borders. International tax law is the corpus of rules regulating the taxation of such activities. These laws often do not keep up with the rapidly developing business environment. Therefore, international tax rules (source and resident principles) often conflict which each other, leading to unintended non-taxation. These legal differences, which make strategic tax planning possible, create an effect that experts call "base erosion and profit shifting", or BEPS. This is a term generally used to describe any tax planning strategy or technique that relies on differences, mismatches and gaps that exist between the tax systems of two or more jurisdictions with the aim of minimizing tax liability. This can be achieved through artificial transactions to reduce or shift profits to low tax jurisdictions even if there is little or no genuine activity. Tax motivated cross-border loans represent only one instrument. Traditional concepts of PE, for

example, can easily be manipulated leading to an ineffective nexus which is, nonetheless, required to rightfully tax an undertaking.

In a situation where the parent company registered the headquarters for its central management in one country while business activities are executed across the border through subsidiaries, the complex question of which jurisdiction is eligible to tax the income derived through this structure is raised. Other questions arise such as: what is the tax base, and at what rate should that base be taxed? This issue causes a global tax disharmony because every jurisdiction involved wants to tax the income for its own good. BEPS tax planning strategies are not illegal per se, but they take advantage of different tax rules operating in different jurisdictions. The erosion of a State's budgetary revenue can have enormous consequences. Specifically, they cause difficulties in the European Union. As previously seen, hybrid mismatches may be used to exploit differences in countries' tax rules and to achieve (i) multiple deductions of the same expense, (ii) deduction of a payment in the country of the payer but no corresponding income inclusion in the payment recipient's country or (iii) multiple tax credits for a single amount of foreign tax paid. Thus, hybrid mismatches give rise to numerous competition policy issues by raising questions about rightful taxation.

3.1. *Inter-Juridical Tax Competition causes the use of Hybrid Mismatches*

The increase of international competition in the field of tax is the natural result of progressive globalization of cross-border trade and investment, as well as the consequence of international economic integration, which transforms the world into a single market. Moreover, the increasing use of technology in the world of business and the persisting disappearance of exchange controls form perfect conditions for companies to shift capital investments worldwide. These aspects of globalization ease the process of cross-border business transactions and foster the use of hybrid vehicles to achieve the lowest possible tax bill for MNE's. While there are various forms of tax competition, this research focuses solely on horizontal tax competition, which is often referred to as inter-juris-

dictional tax competition and exists between sovereign states or bodies on the same level.

They also have comparable powers at the international level, like the OECD and EU. Therefore, it can be said that tax competition affects the major countries of the world. This kind of competition is a nip-and-tuck race to reduce tax burdens for MNE's in forms of low direct tax burdens, special tax incentives or preferential definitions of entities and/or transfers or financial instruments, also known as non-tax competition[22]. The goal is to attract and retain Foreign Direct Investment (FDI) into their territory for various reasons. The concept of tax competition is similar to the one usually referred to in private law (i.e. competition law) between private parties that are engaged in the same line of business. It is defined as the act or process of trying to get or win something that someone else is also trying to get or win. Fair competition refers to lawful and loyal ways of achieving a better market position, whereas unfair competition refers to dishonesty and deceptive means of undermining the market, which often includes fraudulent practices (e.g. unlawful state aid). Consequently, the concept implies that there may be desirable tax competition (i.e. boost of a country's economy to benefit all taxpayers) and harmful tax competition (increase of capital influx or foreign businesses at the expense of other countries' economies).

Sovereign states increasingly struggle because they are required to redouble their efforts in attracting FDI into their jurisdiction, which increases tax revenue to improve the overall welfare of their territory[23].

MNEs often establish their headquarters in low tax jurisdictions, aiming to channel the majority of profits through hybrid arrangements into that State. From a competition point of view, a reduction of tax rates as an example of direct tax competition is generally acceptable. Furthermore, it is considered desirable or good tax competition if it leads to a higher level of public welfare, internal efficiency and/or improvement of overall attractiveness compared to

[22] Financial incentives granted such as interest and exchange rates refer to non-tax competition and have similar objective than direct tax competition i.e. they are targeted at specific economic goal and improve the competitiveness of a country.

[23] A. J. EASSON, «Tax Competition and Investment Incentives», *EC Tax Journal*, 1997, pp. 9 and ff.

other countries. In other words, when a state engages in good tax competition by lowering its tax rates to attract FDI, it should then simultaneously improve its overall performance in terms of the efficiency (lowest possible costs) of government administration, which would ultimately lead to lower tax rates; this would result in a higher level of fairness for all taxpayers. Furthermore, Edwards and Keen[24] argue that governments should be prohibited from growing so as not to raise more taxes. From that perspective, competition of tax systems may cause States to develop new laws and lead to an improvement of the law itself.

Tax competition is considered harmful when it reaches levels of so-called 'the race to the bottom'[25], also known as fiscal degradation. This downward spiral is commonly related to extreme governmental deregulation of taxes and tax relevant factors of the business environment to attract and retain economic activity in form of FDI into their jurisdiction. The evidence for the existence of this effect is the so-called "fiscal reaction function". This function concludes that a 10% higher tax rate in neighbouring countries implies an 8% higher rate in a particular European country. This shows that governments of OECD and EU countries systematically respond to each other's corporate tax rates and compete with their tax rulings against each other[26].

Depending on the stage of the competition, a country only increases its wealth at the expense of another country. However, an overall loss of the global revenue occurs because the total tax liability collected decreases due to overall declining tax rates. In the long run, this vicious circle with respect to tax would

[24] J. Edwards & M. Keen, «Tax Competition and Leviathan», *European Economic Review*, 1996, p. 113; S. SINN, «The Taming of Leviathan: Competition Among Governments», *Const. Pol. Econ.*, 1992, p. 172.

[25] The term "race to the bottom" was coined in 1933 by U.S. Supreme Court Justice Louis Brandeis with regard to the competition among U.S. Federal States in the area of company law: 'Companies were early formed to provide the charters for corporations in states where the cost was lowest and the laws least restrictive'. U.S. Supreme Court, Ligget Co. V. Lee [288 U.S. 517, 558-559 (1933)].

[26] R. A. MOOIJ, *A minimum corporate tax rate in the EU combines the best of two worlds*, International Monetary Fund, 2004; R. ALTSHULER & T. J. GOODSPEED, *Follow the Leader? Evidence on European and U.S. Tax Competition*, Rutgers University, 2002; BESLEY *ET AL.*, *Fiscal Reaction Functions, mimeo, Institute for Fiscal Studies*, 2001; M. DEVEREUX *ET AL.*, «Do Countries Compete over Corporate Tax Rates?», CEPR Discussion Paper No. 3400, 2002.

erode the tax base and impoverish the State. Even if competition law does not set a limit on what is meant by 'minimum' and 'maximum', it is generally clear when it reaches the bottom of the spiral, which represents the most critical point where the cost of granting tax benefits exceeds the actual expected generated benefits. Therefore, society at large suffers[27]. Authorities can also form cartels by coordinating or harmonizing tax laws to regulate or manipulate tax laws for their own benefit. These tax cartels are more harmful than commercials ones due to commercial decisions being made frequently whereas tax policy decisions are made rarely[28]. The conclusion that can be drawn is that eventually tax rates fall to zero, which is supported in the following case[29]; Africa has developed parallel tax systems in which rates have almost fallen to zero[30] as nations have been bidding against each other to attract investment.

3.2. *Juridical Differences attract FDI*

The EU, to this day, consists of 28 MS forming the internal market. Because there are differences in tax systems and compliance requirements regarding corporate entities, financial instruments and transfers are obvious. Furthermore, the Davos World Economic Forum regularly publishes the 'Global Competitiveness Reports', which identify various legal factors of the national legal system that inhibit or promote business activities. Some countries even advertise their own legal system. Germany, for example, promoted its law under the title 'Law Made in Germany' as 'global – effective – cost efficient'[31]. These dif-

[27] J. S. RIBEIRO, «Distributive Justice Through Taxation: European Perspective», *Jurisprudencija*, 2006, pp. 80-89.

[28] N. E. MITU, *Tax competition – Areas of display and effects*, University of Craiova, Faculty of Economics and Business Administration, Romania, 2016.

[29] R. TEATHER, «Economic Analysis of Tax Competition», *The Benefits of Tax Competition*, The Institute of Economic Affairs, 2005, S. p. 42.

[30] S. M. ALI ABBAS, A. KLEMM, S. BEDI & J. PARK, *A Partial Race to the Bottom: Corporate Tax Developments in Emerging and Developing Economies*, Fiscal Affairs Department, IMF Working Papers, 2012.

[31] A. PETERS, «The Competition between Legal Orders», *International Law Research*, 3 (1), 2014, pp. 45-65; The Federal Chamber of German Civil Law Notaries (Bundesnotarkammer), the German Federal Bar (Bundesrechtsanwaltskammer), the German Bar Association (Deutscher Anwaltverein), the German Notaries' Association (Deutscher Notarverein) and the German Judges

ferences in tax systems cause several distortions in the internal market. As highlighted previously, in today's globalized world, capital is highly mobile and businesses can choose to invest in any number of countries to find the highest rate of return. In other words, businesses look for countries with lower tax rates and beneficial legal definitions of entities and financial instruments on investment to maximize their after-tax rate of return. These mismatches not only generate significant differences in the cost of capital, but they also influence MNEs' choices on the location of their investments as well their decisions on the legal financial aspects of such investments. If a country's tax rate is too high, it will drive FDI elsewhere, leading to slower economic growth.

3.3. *Classification Differences: An Example*

The continuous existence of HMA is not influenced by tax rates alone, but also by legal definitions, illustrated as follows. Dutch tax law, as well as in many other tax systems, allows a tax deduction on the remuneration from debt but does not allow a deduction for the remuneration from equity (the distribution of profits) for tax purposes. The Dutch system levies WHT on the distribution of profit but not on interest payments (some exceptions apply). In other words, both interest and profit distributions are taxable at the level of the recipient. Furthermore, Dutch tax laws allow a tax exemption in terms of a participation exemption derived from equity investments in a subsidiary under certain conditions.

Various court cases resulted in an applicable framework to classify debt as equity for Dutch tax purposes. If a financial instrument is considered debt or equity, it is generally determined by civil law[32]. The Dutch Supreme Court in the Caspian Sea Case pointed out that the main characteristic of a loan under Dutch tax laws is the obligation of a repayment by the debtor. In other words, if the recipient has no obligation to repay the loan, then that financial instrument

Association (Deutscher Richterbund) (Eds.), Law Made in Germany, *http://www.lawmadeingermany.de*.

[32] NL: SC, 27 Jan. 1988, BNB 1988/217.

is not considered a loan[33] and treated as equity, disqualifying it for a deduction. This example solely focuses on participating loans. A participating loan is treated as equity if three characteristics are fulfilled: (i) the remuneration on the loan depends on the profit of the borrower, (ii) the loan is subordinated to the claims of all other creditors and (iii) the loan has no term or is perpetual (a loan having a term more than 50 years is considered to have this condition[34]). In other words, for a participating loan to qualify as debt, all the aforementioned characteristics must not be met to qualify for tax deductibility. Consider the following example of Australian RPS in a Dutch context. A Dutch corporation has an interest in an Australian company to which it had granted shareholder loans. After a restructuring, the Dutch business received newly issued RPS from the Australian company and shareholder loans are repaid. The specific characteristics of the RPS are (i) the shares pay a cumulative preferred dividend, (ii) they do not have any voting rights and (iii) the redemption period takes place within ten years. The restructuring of the Dutch corporation leads to an application of the participation exemption regarding the income of the RPS. This means that the payments of the Australian RPS were deductible for Australian tax purposes but not taxed for Dutch tax purposes, which represents a hybrid financial instrument (D/NI Structure). This was not the case before the restructuring process because the Dutch company was then effectively taxed on the interest received from that loan.

The Lower Court[35] decided that the RPS fulfilled the requirements of a loan and thus are deductible for Dutch tax purposes because they had a fixed maturity of less than 50 years, as well as a fixed interest rate that did not depend on the profits of the Australian enterprise. Therefore, they did not represent any voting rights. In conclusion, the Australian RPS had similar characteristics as the common Dutch preferred shares which are eligible for the participation exemption[36]. Following this example, there may be two questions remaining: (i) Should the RPS be classified as debt rather than equity? and (ii) Should

[33] NL: SC, 27 Jan. 1988, BNB 1988/217); NL: SC, 8 Sept. 2006, BNB 2007/104.
[34] NL: SC, 25 Nov. 2005, BNB 2006/82).
[35] NL: LC Haarlem (Rechtbank Haarlem), 25 Jan. 2011, 09/3391, VN 2011/32.12.
[36] NL: AC Amsterdam (Gerechtshof Amsterdam), 7 June 2012, 11/00174, VN 2012/40.11.

the application of the participation exemption be denied because it breaches the Abuse of Law Doctrine? One could argue that the sole purpose of the restructuring was to create a D/NI Structure to reduce tax liability and that it, therefore, infringes upon the Abuse of Law Doctrine. The doctrine states that all transactions may be reclassified or ignored for tax purposes if: (i) the predominant purpose of the restructuring is to avoid tax liability and (ii) if taxes which are not levied on that transaction would go against the principles of the relevant tax rules[37]. The Court of Appeal argued, however, that the Dutch enterprise should be free to decide whether to invest in the Australian company in terms of RPS or in terms of any another financial instrument. If the Court decides against this matter, a company would not be free to do so anymore. In other words, any company would be restricted in making use of this particular finance tool. The idea behind this is that the participation exemption's sole purpose is to mitigate double tax issues on the same profits. Its purpose is not the removal of any consequences which may or may not arise from juridical classification mismatches of a cross-border financial instrument. Therefore, the Abuse of Law Doctrine does not apply. In conclusion, the Dutch company simply benefitted from a mismatch between two tax systems[38] which ultimately benefited the Netherlands in the decision of FDI.

4. Policy Options to Correct Hybrid Mismatches and its Impact on Competition

The previous chapters have shown that the lack of coordination on tax rules in the internal as well as the international market are the main causes of economic distortion and the existence of hybrid arrangements. This shortcoming makes European undertakings compete under different tax rules, which has an enormous impact on the overall goal of the EU: a level playing field. It also affects the international sphere since different jurisdictions provide preferential administrative and favourable tax practices, which create unfair conditions that

[37] NL: AC Amsterdam (Gerechtshof Amsterdam), 7 June 2012, 11/00174, VN 2012/40.11.

[38] G. GELDER & B. NIELS, «Tax Treatment of Hybrid Finance Instruments», *Derivatives & Financial Instruments*, July 2013, pp. 140-148.

lead to an overall lower tax bill for all countries involved as well as a lower worldwide prosperity. Numerous countries have introduced rules which specifically deny benefits arising from certain HMA. These policies centre around the aim to link domestic tax treatment of an entity, instrument or transfer involving a foreign State, with the tax treatment in that foreign State. While the rules are present in several countries, they also present differences regarding their mode of application, scope and overall effects. Examples that have been implemented are examined in the following sections highlighting general anti-avoidance rules (GAAR) and specific anti-avoidance rules: Controlled-Foreign-Company Rules (CFC), the concept of thin capitalization, the Common Consolidated Corporate Income Tax Base (CCCTB) as a tool for the EU, and finally, the BEPS Action Point 2: Neutralize Hybrid Mismatch Arrangements.

4.1. *GAAR*

GAARs are statutory rules that empower the tax authorities to re-characterize a transaction or a series of transactions that have been entered with the main purpose of obtaining an impermissible tax related benefit[39]. For example, effective GAAR can re-classify a loan arrangement into an equity instrument that then denies a deduction on the remuneration of capital (Hybrid Financial Instruments). Many national provisions contain such rules either in the form of an expressed provision incorporated into the tax code or in the form of a general principle of abuse of law developed by local judges in domestic case law. Others are considering the introduction of one or a few fine tune current provisions. The scope of these rules varies from jurisdiction to jurisdiction, which illustrates the diversity of GAAR around the world. The ultimate purpose of all provisions is to stop unacceptable tax avoidance practices[40]. The provisions are considered the last resort, capable of being invoked by an authority[41]to strike

[39] PwC, *Tax Controversy and Dispute Resolution Alert. Preventing – Managing – Resolving Tax Audits and Disputes Worldwide*, PriceWaterhouseCoopers, 2012, pp. 1-14.

[40] R. RUSSO, «General Anti-Avoidance Rules», *Fundamentals of International Tax Planning*, Amsterdam, IBFD, 2007, S. pp. 207-211.

[41] C. WAERZEGGER & C. HILLIER, «Introducing a General Anti-Avoidance Rule (GAAR)», *Tax Law IMF Technical Note* (1), 2016, pp. 1-10.

down unacceptable tax avoidance practices that would otherwise comply with the terms and statutory interpretation of the tax laws of a State. They are typically designed to catch those otherwise lawful practices that are found to undermine the intention of the tax law, like where a taxpayer has misused or abused that law[42]. Tax risk management is, therefore, of utmost importance to stakeholders and MNEs.

4.2. *Controlled Foreign Company Rules to limit HMA*

Governments lose substantial revenue because of tax planning strategies that aim to erode the taxable base by shifting profits to jurisdictions where they are subject to more favourable tax treatment while simultaneously moving expenses where they are relieved at a better rate. These strategies often use a deferral in the same way that they use a foreign corporation located in a low-tax country. The result is that there is no taxation of the low taxed profits at the level of the ultimate parent company[43]. Tax planning is technically legal and thus, widely accepted among tax planners and MNEs. The base eroding results, however, are not intended by domestic policies and cause distortions in the Internal Market and international sphere.

Controlled Foreign Companies legislation (CFC) has been developed for a variety of purposes. Generally, it empowers a state to tax its resident taxpayers on income derived by a foreign entity controlled by that resident taxpayer. The possibility of having control over a foreign entity allows the resident taxpayer to channel income to that foreign entity and to defer the profit distribution by a non-resident entity, which ultimately leads to a tax deferral until the profits of the foreign company are repatriated (in the form of dividend or capital gain) to them, if they ever are. On the one hand, CFC rules focus on tax avoidance transactions, and on the other hand, they may function as an instrument to eliminate the deferral of tax on income that is solely realized through foreign subsidiary. They are an effective tool to prevent harmful tax practices. CFC rules define the independence of a company, whereas the determination

[42] *Ibid*.

[43] OECD, *Addressing Base Erosion and Profit Shifting*, Paris, 2013.

can be based on shareholders and stakeholders having a controlling interest in a company as well as the percentage of their control (Hybrid Transfers). Minimums can range from 10 to 100 people, 40 percent of voting shares[44], or 20 percent of outstanding shares[45]. In this way, the State can levy taxing rights to ensure lawful taxation of an enterprise. Domestic law usually contains rules that allow a sovereign state to tax the income that is derived through a controlled foreign company to eliminate the benefit derived from the deferral.

A critical aspect when attempting the implementation of CFC rules is determining whether these rules are restricted by the effect of tax treaties. Furthermore, it must distinguish whether CFC rules concern subsidiaries resident in another MS: a MS of the European Economic Area (EEA) or a subsidiary resident in a third country. In cases where CFC rules concern subsidiaries resident in another MS, that MS must be assured that such rules are in line with the Community law provisions to avoid disproportionate restrictions on cross-border activities within the EU. In the case where CFC provisions concern subsidiaries in third countries, such provisions could be restricted by a double tax treaty[46].

4.3. *Thin Capitalization*

Initially, thin capitalization rules are introduced to prevent a taxpayer from excessively borrowing money from a related party usually located in another jurisdiction. In that way, the taxpayer can deduct the debt interest for tax purposes while the recipient is not taxed on that interest. A company is deemed thinly capitalized if the level of its debt is much greater than its equity capital, which results in a disproportional debt-to-equity ratio. Various tax authorities challenge thin capitalization under domestic anti-abuse provisions, transfer pric-

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[44] Voting shares are shares that give the stockholder the right to vote on matters of corporate policy. For example, the composition of members of the board of directors.

[45] Outstanding shares are connected to a company's stock currently held by all its shareholders.

[46] M. HEIDENREICH, «CFC Rules as an Instrument to Counter Abuse», in K. SIMADER & E. TITZ, *Limits to Tax Planning*, Vienna, Linde, 2013; M. COTRUT *ET AL.*, *International Tax Structures in the BEPS Era*, Amsterdam, IBFD, 2013, p. 224.

ing rules, or specific rules such as the arm's length principle and very frequently, fixed debt-to-equity ratios, to determine the maximum excess. These fixed ratios differ significantly from country to country. Debt-to-equity ratios have little relevance as they do not take relevant facts of the situations into account. They can only serve as a basic preliminary filter[47]. It is impossible to identify the certain threshold for such ratios because they not only differ from country to country but also cross industries[48]. Due to these variances, it is impossible to define a uniform ratio that fits all thresholds. Another issue which may be concerning is the definition of the term debt.

4.4. *CCCTB*

Direct taxes have only been harmonized to a very limited extent within the EU. The previous chapter highlighted how the differences in CIT foster mismatches and government revenue. Furthermore, they are also a cause for concern because they distort the international market and the EU market. The differences between MS administrative practices also cause distortions of competition within the EU. A company that consolidates its tax liability in a fiscal year has a clear advantage over an enterprise that has to comply within a month or a quarter. Today, there are only four directives describing the tax treatment of European intra-group reorganizations, dividends and royalty payments[49]. The proposal to have a Common Consolidated Corporate Tax Base (CCCTB) is a potential tool to coordinate various accounting and administration systems in the Internal Market. The CCCTB makes it impossible for MNEs to take its profits from one EU Member State and to hide them in a tax haven situated inside the EU. This measure will prevent companies from tax planning to avoid taxa-

[47] G. ZEHETMAYER, «Thin Capitalization Rules as an Instrument to counter abuse», *in* K. SIMADER & E. TITZ, *Limits to Tax* Planning, Vienna, Linde, 2013, S. p. 253.

[48] STORCK, «The Financing of Multinational Companies and Taxes: An Overview of the Issues and Suggestions for Solutions and Improvements», *Bulletin for International Taxation*, 2011, p. 30.

[49] (i) Council Directive 2011/96/EU of 18 January 2012 (The Parent-Subsidiary Directive); (ii) Merger Directive Council Directive 90/434/EEC of 23 July 1990; (iii) Council Directive 2003/49/EC of 3 June 2003; (iv) Council Directive 2003/48/EC of 3 June 2003, Savings Directive.

tion as the rules eliminate mismatches between national systems and preferential regimes. Dual residency will especially be outweighed because a group of companies will have to consolidate only one single tax return.

4.5. *OECD BEPS Action Plan*

The OECD is the leading organization in promoting international tax cooperation in the fight against base erosion and profit shifting to ensure the realignment of the location of the profits with the location of the activities; this is notably achieved through the establishment of the Global Forum on Transparency and Exchange of Information. The OECD recently launched an initiative on BEPS that has less to do with non-compliance because in many cases, tax planning strategies are technically legal. The BEPS Action Plan addresses the fundamental issue: international tax rules have not managed to keep up with the changing business environment.

Several countries have introduced rules which purposely deny the benefits created by HMA. They address specific situations, i.e. multiple deduction, deduction/no inclusion effects or other forms of tax relief, e.g. foreign tax credit generators. These strategies must operate within the context of the respected tax system, administrative practices and culture. Therefore, it is up to each country to decide how to approach the issues of HMA and which strategies would be the most appropriate in the context of, and most consistent with, the domestic rules. However, only a few countries have implemented rules which target the issue raised by hybrids on a comprehensive basis. Furthermore, various countries apply a variety of legal definitions that leads to complex compliance issues and makes harmonization more complicated.

Many of the rules do not seek to address the characterisation of the hybrid entity or instrument itself, but only seek to address the tax consequences of the HMA. To provide a solution to HMA, the OECD recommends linking rules which particularly target these arrangements by likening the domestic tax treatment to the foreign tax treatment. Basically, the response rule denies the payer a deduction for the payment made under the hybrid financial instrument if the recipient jurisdiction does not tax the payment as ordinary income.

5. Final Conclusion

Tax transparency is an essential element in combating corporate tax avoidance; it describes the extent to which an enterprise's tax information is observable to outsiders. The availability of timely, targeted and comprehensive information is essential for governments to quickly respond to risk areas. Often, audits remain the main source of information for the early detection of abusive behaviour. Moreover, relevant information on tax strategies is often unavailable to the tax administration[50]. A high level of transparency is the consequence of regulations, local norms, sets of information, privacy and business policies concerning tax openness to employees, stakeholders, shareholders and the general public. Corporate taxation matters, however, are currently at a low level of transparency.

Furthermore, the EU has actively participated in the entire BEPS process, and therefore, it is incumbent upon the Community to pave the way for a trouble-free implementation of the proposal. The Commission set an ambitious agenda to facilitate fairer and more effective corporate taxation. Thus, the EU should move closer together and narrow the massive gap between CIT among Individual MS (CIT ranging from 12.5 % in Belgium to 33 % in France), which creates a major obstacle from a competition policy perspective. Although full harmonization of CIT has not been achieved and is considered unachievable, MS should take their own initiatives to lower the CIT gap. Although this recommendation is rather ambitious, it is a way to reduce the distortional effects of CIT. These conditions will facilitate a more equitable business environment and benefit all market players. In this manner, the MS maintain their fiscal sovereignty while the EU, at the same time, balances overall competition. The harmonization of CIT would not be sufficient as it does not constitute a final solution in the fight against harmful competition. Countries further compete, through accounting and administrative rules, to attract foreign investment. Therefore, the EU is advised to revamp the CCCTB proposal and to introduce this exigent tool in the near future. The implementation can be facilitated by a

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[50] OECD, *Action Plan on Base Erosion and Profit Shifting*. Paris, OECD Publish, 2013.

substitution of the unanimity rule by a qualified majority vote. With the help of a qualified majority vote, a law is adopted once a specific threshold of votes in the Council of Ministers is obtained. In this way, the overall legislative procedure regarding the Internal Market would be simplified; it also ensures an efficient imposition of a tax framework which is urgently required within the market.

This report clearly showed that international tax planning through HMA has become an important item on the political agenda. This represents a significant development which has resulted in countries entering a bipartisan debate proposing that international tax rules need to be fixed. Because sovereign States deliberately use their tax systems to compete against each other to advertise their jurisdiction as the most attractive for FDI, tax competition between MS creates a setting for these mismatches to occur. In a world without differences, tax competition would not appear. However, in the real world, there are major differences between tax laws of sovereign States which fuel competition and makes the matter even more pressing. In particular, highly mobile assets are manipulated within complex hybrid mismatch structures that take advantage of juridical differences. In that way, these arrangements generate a tax benefit through DD, D/NI structures or foreign tax credits, which ultimately lowers the taxable base of two or more jurisdictions. These mismatches enhance the differences and maximize the downsides of competition and their resulting problems. Although this effect may not be intended by either country, States indirectly contribute to the existence of these structures by allowing enormous legal mismatches. The question often posed is why? As illustrated, this results because some States take advantage of these differences and adapt their legislation, or even fight against anti-abuse rules implemented by major economies. They, thereby, permit mismatches caused by a variety of factors from geographical distance to more country development, with the ultimate aim of ensuring governmental revenue and prosperity. Thus, it can be asserted that tax competition, a modern form of economic rivalry, inevitably fosters the use of HMA. This research shows that inter-juridical tax competition under the current setting is more likely to increase and intensify because States that are at an economic disadvantage find and pursue other ways to attract companies in their

jurisdiction. Even though the EU and the OECD laudably aim for a harmonized approach (which would ultimately lead to the end of fiscal competition that was triggered by mismatches and other schemes or differences), it would be naive to presume that, even though these anti-harmonization governments join the OECD BEPS Plan, they will really participate. Indeed, harmonization has an impact on the structures illustrated in this research, but not all States follow that approach and continue to compete under different settings. The outcome is likely that harmonized economies compete with the opposing disharmonized economies. Tax payers certainly have been, and still are, creative in finding other ways to obfuscate the source of income to minimize their fiscal exposure. Several policies at the disposal of various countries aim to eliminate the effects of hybrid mismatches. The research interestingly reveals that domestic anti-abuse rules are rather broad. Although they have similar features, rules are not identical in any two jurisdictions due to sovereignty. In particular, the BEPS Plan fixes domestic rules so that massive international tax planning by MNEs is not facilitated by any jurisdiction. There are companies operating globally, but domestic legislation lags behind because countries tenaciously cling onto their sovereignty. This issue leads to gaps and facilitates the use of HMA. Therefore, the actors are not only MNE's exploiting the current situation, but countries are also actively complicit by prolonging disharmony in their tax laws. Moreover, governments actively engage in inter-juridical tax competition by allowing these schemes to occur for various reasons. Why else would a country apply a zero withholding tax rate on dividends and royalties to a tax haven that simply invites a company to come through their door? However, despite the tools against HMA, they all centre around the common goal. Therefore, these arrangements are at risk, and developing policies will definitely impact the taxpayer's decision about whether to make use of such arrangements and tools. Fighting base erosion and profit shifting became a politically sensitive issue that requires an international and coordinated approach. Most of the instruments that tackle the tax issues will not work if no political consensus is found to change the situation. *'The BEPS proposal is like a 'root canal' which is painful but*

inevitable, and that many of us can see its 'x-ray' which is the 'Country-by-Country' reporting', according to Kaka («International Taxation Conference 2016», p. 1)[51]. The aim of the proposal is not to raise government revenue but to realign the location of the business activities with the location of the profits, because too much profit is currently shifted into so called tax havens through pure contractual arrangements. In that way, international standards are developed which will hopefully put an end to, or at the very least, severely curtail, harmful tax competition. Moreover, these standards help level the playing field so countries can compete under fair conditions. It only remains to be seen which measure will predominantly be used to combat and ultimately stop hybrid entity mismatches.

[51] P. KAKA, «International Taxation Conference – 2016 – BEPS AND BEYOND BEPS: A YEAR LATER», *Taxsutra*, 2016, S. p. 1.

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PART II

OTHER CONTRIBUTIONS

Prorogation of Jurisdiction in Brussels I *bis* Regulation

Anabela Susana de Sousa Gonçalves *

1. Brussels I *bis* Regulation

The legal framework of the prorogation of jurisdiction in civil and commercial matters in the European Union is found in *Regulation No. 1215/2012 of the European Parliament and of the Council, of 12 December 2012, on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters* (Brussels I *bis*).

The Brussels I *bis* Regulation is an important instrument of the European Union (EU) policy concerning judicial cooperation in civil matters[1], and unifies, within the EU, the rules of jurisdiction (from Article 4 to Article 35), and the rules about recognition and enforcement of judgments and of authentic instruments and court settlements (Article 36 and Article 60).

Brussels I *bis* Regulation governs civil and commercial matters according to the provisions of Article 1, Section 1, the issues listed in Sections 1 and 2 of the same legal provision being excluded from its scope like: status and legal capacity of natural persons, rights in property arising out of a matrimonial relationship and comparable relationships, maintenance obligations, resulting from family relationship, parentage, marriage or affinity, wills and successions; bankruptcy, revenue, customs and administrative matters, the liability of the State for acts and omissions in the exercise of State authority. Furthermore, in what concerns the material scope of the application of the Regulation, it is mandatory for the existence of international elements to be a part of the situation, since

* Professor of Law at the School of Law of University of Minho, Braga, Portugal.

[1] About the politics of judicial cooperation in civil matters, see ANABELA SUSANA DE SOUSA GONÇALVES, «Cooperação Judiciária em Matéria Civil», *Direito da União Europeia, Elementos de Direito e Política da União*, ed. Alessandra Silveira, Mariana Canotilho, Pedro Madeira Froufe, Almedina, Coimbra, 2016, pp. 339-391.

the Regulation does not apply to purely internal situations[2]. Thus, the Regulation is applicable to those situations which are in contact with more than one legal system.

The international jurisdiction rules of the Brussels I *bis* Regulation have their special scope of application in situations where the defendant has its domicile in one of the Member States (Article 4, Section 1). Otherwise, the national jurisdiction rules of the Member States will be applicable, except in the situations identified in Article 6, Section 1: in cases of consumer contracts (Article 18, Section 1); employments contracts (Article 21, Section 2); exclusive jurisdiction (Article 24); and choice-of-court agreements (Article 25). In those situations, there can be jurisdiction of the Member States' courts, regardless of the place of residence of the defendant. In turn, the recognition and enforcement rules will apply to the judgments issued by the Member States' courts included within the material scope of the application of Brussels I *bis* Regulation, according to its Article 36. The Regulation also applies to the recognition and enforcement of authentic instruments and court settlements originating from one the Member States in other Member States within its material scope of application, according to Articles 58 and 59.

Brussels I *bis* Regulation has been in force since 10 January 2015 (Article 81) and has repealed *Regulation no. 44/2001, of 22 December 2000, on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters*, known as Brussels I[3] (Article 80)[4].

[2] Condition claimed in Jenard Report and in Schlosser Report, as well as in several ECJ decisions: P. JENARD, R*eport on the Convention, of 27 September 1968, regarding the judiciary competence and enforcement of judgements in civil and commercial matters*, JO C 189, 1999, p. 8; P. SCHLOSSER, *Report on the Convention on the Association of the Kingdom of Denmark, Ireland and the United Kingdom of Great Britain and Northern Ireland to the Convention on jurisdiction and the enforcement of judgments in civil and commercial matters and to the Protocol on its interpretation by the Court of Justice*, JO C 189, 1990, § 21; ECJ, *Andrew Owusu versus N. B. Jackson, acting under the commercial name Villa Holidays Bal-Inn Villas*, Case C-281/02, 1.3.2005, § 25, still regarding the *Brussels Convention, of 27 September 1968 regarding the judiciary competence and enforcement of judgements in civil and commercial matters* (Brussels Convention), among others.

[3] Regulation no. 44/2001 came into force in 1 March 2002, according to its Article 76, being established, in Article 66, Section 1, that the provisions in this Regulation are applicable to legal proceedings instituted to authentic instruments formally drawn up or registered and court settle-

The prorogation of jurisdiction is a common practice in international trade, especially in international contracts, and Brussels I *bis* establishes its legal framework to be applicable in the European Union. It is true that there are special rules in relation to choice-of-court agreements regarding insurance contracts (Article 15), consumers contracts (Article 21) and employment contracts (Article 23), which stipulate the need to protect the weaker party of the contract. However, these special regimes are excluded from the scope of this study that will analyse the general legal framework of the choice-of-court agreements, established in Article 25, and the choice-of-court by submission, set in Article 26.

2. Choice-of-Court Agreements

The advantages of a choice-of-court agreement to the parties are numerous and well recognized. The possibility of the parties selecting the *forum* is a recognition of the principle of freedom of choice and allows them to shape their legal relations in procedural terms. The parties shall choose a certain jurisdiction according to their interests, while also taking into consideration: the law applicable by that court, the easiest production of proof, the proximity of the court with a possible or effective litigation, the speed in resolving a dispute; easier procedure of recognition and enforcement of the decision, coincidence *forum-ius* and the possibility of concentrating related disputes in the courts of the same State... At the same time, the choice-of-court agreement, in addition to recognising the sphere of freedom of individuals, creates certainty, security and predictability in relation to the jurisdiction. This also helps to reduce delays that may result from settling in the right jurisdiction, which produces gains in terms of an expedited resolution of the litigation, as it increases the predictability of the *forum* and applicable law. The importance of the choice of forum agree-

ments approved or concluded on or after 10 January 2015 and has superseded between Member States of the Brussels Convention, adopting its structure and, in large part, its text (Article 68).

[4] About the main modifications introduced by Brussels I *bis* to the previous Regulation, see ANABELA SUSANA DE SOUSA GONÇALVES, «A Revisão do Regulamento Bruxelas I Relativo à Competência Judiciária, ao Reconhecimento e à Execução de Decisões em Matéria Civil e Comercial», *Estudos em Comemoração dos 20 Anos da Escola de Direito da Universidade do Minho*, ed. Mário Monte *et al.*, Coimbra Editora, Coimbra, pp. 39-59.

ments in international trade is obvious as the European Commission has identified that 70% of European companies that sell products or provide services on the European market use choice-of-court agreements in international contracts[5].

The choice-of-court agreements are regulated in Article 25 of Brussels I *bis* Regulation, allowing the parties, by agreement, to assign jurisdiction in legal disputes in civil and commercial matters to a court or courts of a Member State. Choice-of-court agreements were already regulated in Regulation no. 44/2001 (in Article 23), and they are considered to be an expression of the principle of freedom of choice by the parties; the parties are allowed to choose a court or courts of a Member State to settle future disputes or a dispute that has already taken place by allowing the selected court's exclusive jurisdiction to decide, unless otherwise agreed upon by the parties (Article 25, Section 1). Therefore, in harmony with the principle of freedom of choice, the selected court should settle the dispute, excluding the jurisdiction of any other court that might have jurisdiction according to the rules of the Regulation[6]. The choice of the court by the parties will grant exclusive jurisdiction to that court, given that the parties have not agreed upon otherwise and if the agreement is not null and void as to its substantive validity under the law of the Member State where the court or courts were chosen (Article 25, Section 1).

Note, however, that the choice-of court agreement cannot cast out the other court´s exclusive jurisdiction under Article 24, nor the protective jurisdiction that the Regulation establishes to the employment, the consumer or insurance contracts, according to Article 25, Section 4. In fact, one of the grounds for refusing to recognise a judgment is if the judgment conflicts with [Article 45 (e)]: Sections 3, 4 or 5 of Chapter II where the policyholder, the insured, a beneficiary of the insurance contract, the injured party, the consumer or the employee was the defendant; or with Section 6 of Chapter II.

[5] EUROPEAN COMMISSION, *Commission Staff Working Paper Impact Assessment, Accompanying document to the Proposal for a Regulation of the European Parliament and of the Council on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (Recast)*, SEC (2010) 1547 final, Brussels, 14.12.2010, p. 29.

[6] The importance of freedom of choice principle in jurisdiction rules results from recital 11 and is recognized by the ECJ, as it becomes clear in the case *Refcomp SpA versus Axa Corporate Solutions Assurance SA and others*, Case C- 543/10, 7.2.2013, § 26.

Recognising the principle of autonomy of the parties, Article 25 also establishes the formal and substantial limits of the agreement between the parties. The validity of the choice-of-court agreement is dependent on the compliance of certain requirements, established in Article 25, Section 1, to ensure legal certainty and to guarantee that the parties have given their consent[7]. The consensus between the parties must be clearly and precisely demonstrated in the choice of jurisdiction agreement as guaranteed by the substantial and formal requirements.

In the previous version of the rule in the Regulation no. 44/2001 (Article 23), one of the parties had to have its domicile within the territory of a Member State. Moreover, as a substantive condition, the object of the agreement should concern a particular legal relationship[8]. As formal requirements, the agreement should have concluded: in writing or verbally, with written confirmation; in a form according with practices which the parties have established between them; or in a form according to the usage in international trade or commerce, of which the parties know or should know and which in such commerce or trade is widely known to, and regularly observed by parties in contracts of the same type involved in the specific trade or commerce in question. Section 2 of the same Article 23 determined that any communication by electronic means which could allow a durable record of the agreement was equivalent to a written contract. These formal requirements could be applied alternatively, and their goal had to do with the need to safeguard the actual existence of the consent of the parties[9], which was «(...) justified by the concern to protect the weaker party to the contract by avoiding jurisdiction clauses, incorporated in a contract by one party, going unnoticed»[10].

[7] ECJ, *Trasporti Castelletti Spedizioni Internazionali SpA v. Hugo Trumpy SpA.Castelletti*, Case C-159/97, 16.3.1999, § 34; *Francesco Benincasa and Dentalkit Srl*, Case C-269/95, 3.7.1997, § 25; *Hőszig Kft. v. Alstom Power Thermal Services*, Case C-222/15, 7.7.2016, § 32.

[8] ECJ, *Profit Investment Sim SpA, in liquidation v. Stefano Ossi et. al.*, Case C-366/13, 20.4.2016, § 23; *Hőszig Kft. v. Alstom Power Thermal Services*, Case C-222/15, *cit.*, § 33.

[9] As it has been stated by ECJ, *v.g.*, *Powell Duffryn plc and Wolfgang Petereit*, Case C-214/89, 10.3.1992, § 26; *Galeries Segoura SPRL v. Société Rahim*, Case C-25/76, 14.2.1976, § 6.

[10] ECJ, *Hőszig Kft. v. Alstom Power Thermal Services*, Case C-222/15, *cit.*, § 33. See also, ECJ, *Trasporti Castelletti Spedizioni Internazionali SpA v. Hugo Trumpy SpA.Castelletti*, C-159/97, *cit.*, § 24.

Article 25, Sections 1 and 2 of Brussels I *bis* Regulation retains the same text as the previous provision of Article 23, but with one major change: a jurisdiction agreement, regardless the domicile of the parties, can now be settled, without needing one of its parties to have its domicile within a Member State (Article 25, Section 1), as in the previous drafting.

Under Article 25, a jurisdiction agreement established in general conditions referred by the contract should be considered lawful. The ECJ has already held that such a clause is lawful if the contract signed includes an explicit reference to general conditions that include a jurisdiction clause[11]. However, the reference should be expressed, so that it "(...) can be controlled by a party applying normal diligence and (...) that the general conditions containing the jurisdiction clause was actually communicated to the other contracting party"[12].

It is important to consider Section 2 of Article 25, which clarifies that written form is the one that corresponds to *any communication by electronic means which provides a durable record of the agreement.* The explanation of this legal provision is found in the 2001 version of Brussels I *bis* Regulation: it is a way to adapt the rule regarding jurisdiction agreements to e-commerce contracts. In the proposal of the European Commission that introduces the rule, it can be read that "(…) the need for an agreement 'in writing or evidenced in writing' should not invalidate a choice-of-forum clause concluded in a form that is not written on paper but accessible on screen"[13]. It results from the writing of the legal provision that the electronic communication, through which the jurisdiction agreement was settled, shall allow a durable record, which can be better achieved when communications between the parties are done through e-mail. In this case, the electronic communication, where the jurisdiction agreement is

[11] ECJ, *Trasporti Castelletti Spedizioni Internazionali SpA v. Hugo Trumpy SpA.Castelletti*, C-159/97, *cit.*, § 13; ECJ, *Profit Investment Sim SpA, in liquidation v. Stefano Ossi et. al.*, C-366/13, *cit.*, § 26; *Hőszig Kft. v. Alstom Power Thermal Services*, Case C 222/15, § 39.

[12] *Hőszig Kft. v. Alstom Power Thermal Services*, Case C-222/15, *cit.*, § 40. Cfr., ECJ, *Estasis Saloti di Colzani*, Case C-24/76, 14.12.1976, § 12.

[13] European Commission (1999) *Proposal for a Council Regulation (EC) on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters*, Brussels, 14.7.1999, p. 18.

stated, can be stored in the mailbox, in the computer, in an external hard drive or even in print, as a last resource for a durable record[14].

One relevant change in the writing of Article 25, as compared to the previous draft, concerns the validity of the jurisdiction agreement, on which the ECJ had already contemplated. In the case *Francesco Benincasa versus Dentalkit Srl*[15], after defining that the objective of a jurisdiction agreement is the precise and clear designation by the parties of the court that have exclusive jurisdiction (unless otherwise agreed upon), the ECJ considered that the judicial security resulting from that agreement would be impaired if one of the parties could evade what was agreed, by alleging the nullity of the entire contract where that clause was inserted. Therefore, the validity of both must be analysed autonmously, as they are two agreements that should be treated independently[16]. In the same case, the ECJ decided that the nullity of the contract, where the jurisdiction agreement was inserted, should be assessed by the court stipulated for in that agreement[17]. It is this independence of the jurisdiction agreement, regarding the other provisions of the contract, and the prohibition of challenging the validity of that clause based only on the contract invalidity, that Article 25, Section 5 establishes.

The Brussels I *bis* Regulation, also solved an issue, whose solution was not clear in the previous text, and where certain questions arose. Several authors[18] questioned what would be the law that should assess the substantial

[14] About the choice-of-court agreements in the electronic commerce contracts, see ANABELA SUSANA DE SOUSA GONÇALVES, «Choice-of-Court Agreements in the E-Commerce International Contracts», *Masaryk University Journal of Law and Technology*, Vol. 11, No. 1, summer 2017, pp. 63-76.

[15] Process C-269/95, 20.2.1997, *CJ* 1997, p. I-3767.

[16] ULRICH MAGNUS, «Prorogation of jurisdiction», *Brussels I Regulation*, edited by Ulrich Magnus and Peter Mankowski, Sellier European Law Publishers, Munich, 2012, pp. 500-501; F. VISHER, «Der Einbezug deliktischer Ansprüche in die Gerichtsstandsvereinbarung für den Vertrag», *Festschrift für Erik Jayme I*, ed. Heinz-Peter Mansel *et al.*, Sellier European Law Publishers, München, 2004, p. 995.

[17] *Francesco Benincasa contra Dentalkit Srl*, Case C-269/95, 3.7.1997, p. I-3767.

[18] See HÉLÈNE GAUDEMET-TALLON, *Compétence et Exécution des Jugements en Europe, Règlement no. 44/2001, Conventions de Bruxelles et de Lugano*, 3rd ed., Montchrestien, L.G.D.J., Paris, 2002, p. 93, indicating some solutions for the resolution of this problem, as the query of the law of the appointed court and the law of the excluded court, about the validity of the clause; ULRICH MAGNUS, «Prorogation of jurisdiction», *cit.*, pp. 473-474 e pp. 476-478, differentiating the several

validity of the jurisdiction agreement. Article 25, Section 1 of the Brussels I *bis* Regulation, seems to indicate that the substantial validity must be assessed according to the law of the court of the Member State that has jurisdiction, as stated in the choice-of-court agreement (and confirmed by recital 20). What must be understood as law, for the purposes of this rule, is clarified in recital 20, which includes the conflict of law rules of the legal order of the Member State's appointed court[19]. It seems that this option of the Brussels I *bis* Regulation is in line with the autonomous treatment given to the jurisdiction agreement and with the drafting of Article 5, Section 1 of the *Hague Convention, of 30 June 2005, on Choice-of-Court Agreements*, these two legislative texts achieves compatibility[20].

Regarding the interpretation of the content of a jurisdiction clause, it is not necessary that the chosen court only be identified by its wording. According to the ECJ "(...) it is sufficient that the clause state the objective factors on the basis of which the parties have agreed to choose a court or the courts for to where they wish to submit disputes that have arisen or may arise between them"[21]. In addition, those factors, which have to be sufficiently accurate to allow the court seized to determine its jurisdiction, may result of particular circumstances of the case[22].

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substantive questions which might arise related to the jurisdiction agreement; PETER STONE, *EU Private International Law, Harmonization of Laws*, Edward Elgar Publishing, Cheltenham – UK, Northampton – USA, 2008, p. 168.

[19] Hypothesis already admitted by some doctrine, regarding the assessment of the consent declaration: v., *v.g.*, HÉLÈNE GAUDEMET-TALLON *Compétence et Exécution des Jugements en Europe..., cit.*, p. 93; ULRICH MAGNUS, *Prorogation of jurisdiction*, *cit.*, pp. 477-478; PETER STONE, *EU Private International Law*, p. 168. Cfr. about this question, in the revision of the Regulation, JEAN-PAUL BERAUDO, «Regards sur le nouveau règlement Bruxelles I sur la compétence judiciaire, la reconnaissance et l´execution des décisions en matière civile et commercial», *Clunet*, Vol. 3, 2013, p. 749; PETER HAY, «Notes on the European Union´s Brussels-I "Recast" Regulation», *The European Legal Forum*, Vol. 1, 2013, p. 3; A. NUYTS, «La refonte du règlement Bruxelles I», *RCDIP*, Vol. 1, 2013, pp. 55-57; T. RATKOVIC, D.Z. ROTAR, «Choice-of-Court Agreements Under the Brussels I Regulation (Recast)», *JPIL*, Vol. 9 (2), 2013, pp. 251-259.

[20] As it is referred in the proposal of the European Commission, *Proposal for a Regulation of the European Parliament and of the Council on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters*, COM 748 final, Brussels, 2010, p. 10.

[21] *Hőszig Kft. V Alstom Power Thermal Services*, Case C-222/15, *cit.*, § 43.

[22] *Idem*, *ibidem*. In that case, the choice-of-court agreement did not refer expressly to the courts of a Member State, but to the courts of the capital of a Member State (Paris) and the law of

One question that can be posed concerns the validity of a choice-of-court agreement. The agreement, gives jurisdiction to the courts of several Member States, since Article 25, Section 1 allows the possibility of choosing "(...) a court or the courts of a Member State". This situation occurred in the *Nikolaus Meeth v Glacetal* judgment, in which there was a choice-of-court agreement in a contract concluded between *Nikolaus Meeth*, established in Germany, and *Glacetal*, established in France[23]. In the contract, it could be read that "if Meeth sues Glacetal, the French courts alone shall have jurisdiction. If Glacetal sues Meeth, the German courts alone shall have jurisdiction". The ECJ ruled that the legal provision of the Brussels Convention at the time does not exclude the right of the parties to agree on two or more courts for the purpose of settling any disputes which may arise. In this case, the ECJ ruled that the agreement, under which the two parties domiciled in different States, could only be sued in the courts of their respective States[24], to be valid. The ECJ considered that the wording of the Article was not an obstacle to this interpretation: "(...) that wording, which is based on the most widespread business practice, cannot, however, be interpreted as intending to exclude the right of the parties to agree on two or more courts for the purpose of settling any disputes which may arise"[25]. Thus, the parties may agree in a choice of jurisdiction to the courts of more than one Member State, whereby the claimant is allowed to choose.

As to the asymmetric clause that benefits only one of the parties, nothing seems to exclude this clause from the application of Article 25. If the parties decide to favor one of them, allowing by agreement that only one of them can resort to a chosen court or opt between two or more chosen courts, as long as

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that State was also chosen by the parties as the law of the contract. So, the ECJ considered that this choice-of-court agreement fulfilled the requirements of precision demanded by the rule. It held that the jurisdiction clause referring to the courts of a city of a Member State should be interpreted as referring implicitly but necessarily to the system that Member State's jurisdiction rules: *idem, ibidem,* §§ 48-49.

[23] ECJ, *Nikolaus Meeth v Glacetal*, ECR, Case 23/78, 9.11.1978, 1978, p. 02133.

[24] *Idem, ibidem.*

[25] *Idem, ibidem*.

the substantial and formal limits established in Article 25 are complied with, there is no reason not to validate this clause[26].

More doubtful is the validity of a clause that agrees to the exclusion of jurisdiction (derogation agreement) without making a positive designation of the jurisdiction, in other words, without establishing which court has jurisdiction. This kind of clause will appear very rarely because they create uncertainty and, thus, they do not protect the interests of the parties. However, authors are inclined to accept their inclusion and validity under Article 25, with the argument of uniform treatment of the jurisdiction agreement and, by the application of the limits established in that legal provision, to avoid the misuse of this kind of agreement[27]. It is better to have these clauses under the limits of Article 25 than to put them out of the scope of application of the Brussels I *bis* Regulation to ensure the uniform treatment of the jurisdiction agreement as well as legal certainty and security, because Article 25 needs to ensure the consent of both parties to the jurisdiction agreement. Of course, these derogations agreements cannot jeopardize the provisions that aim to protect the weaker party in the contract nor the exclusive jurisdiction rules, as set in Article 25, Section 4. However, if as an effect of the derogation agreement, it is not possible to grant jurisdiction to any court, a solution would be to consider the jurisdiction agreement void on the ground of preventing the access to justice and, as a consequence, the rules of jurisdiction of the Regulation would be fully applied again[28].

Article 25, Section 3, has a provision applicable to legal trust instruments known in the Common Law countries, which fall in the scope of application of the Brussels I *bis* Regulation. A trust is a three-party fiduciary relationship, in which the settlor or trustor orders that the property is held and administered by a trustee, but the trustee has to act in the interest and benefit of a third party,

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[26] With the same opinion, see ULRICH MAGNUS, «Article 25», *ECPIL, European Commentaries on Private International Law, Brussels I bis Regulation*, edited by Ulrich Magnus and Peter Mankowski, OttoSchmidt, Köln, 2016, pp. 607-608.

[27] *Idem, ibidem*, p. 610.

[28] Ulrich Magnus considers that in this case at least the court of the domicile of the defendant should have jurisdiction to guarantee that a jurisdiction is available: ULRICH MAGNUS, «Article 25», *cit.*, p. 610. In my opinion, all the rules of the Regulation should regain application to guarantee equitable access to justice and the objectives of the Regulation.

the beneficiary. According to Section 3 of Article 25, the court or courts of a Member State on which a trust instrument has conferred jurisdiction shall have exclusive jurisdiction in any proceedings brought against a settlor, trustee or beneficiary if relations between those persons or their rights or obligations under the trust are involved. In other words, the settlor can include a jurisdiction clause in the trust instrument, and this clause will bind all three fiduciary parties to the trust, even if the trustee or the beneficiary does not give their consent, because the trust is a one-sided act.

One novelty of the recent version of the Brussels I *bis* Regulation aims to avoid abusive litigation tactics and solve the problem of the *counter Torpedo tactics*, ensuring the effectiveness of choice-of-court agreements. In accordance with Article 26 of the former Regulation no. 44/2001, in cases of *lis pendens*, where proceedings involving the same cause of action and between the same parties are brought in the courts of different Member States, any court other than the court first seized should of its own motion stay with its proceedings until such time as the jurisdiction of the court first seized was established. Where the jurisdiction of the court first seized was established, any court other than the one first seized should decline jurisdiction in favor of that court. This means that the court that was seized first had to determine its jurisdiction or not, and the court seized second could not decide over the jurisdiction of the first court seized[29].This was the solution even when the jurisdiction of the second court seized was the result of a choice-of-court agreement granting exclusive jurisdiction to that court: the court seized in second place should stay with its proceedings until the court first seized considers that it does not have jurisdiction[30]. This created situations where actions that were first brought into a court with proceedings that were deemed too long, the courts with jurisdiction by a choice-of-court agreement were instead obliged to stay for the proceedings. This was a form of abusive litigation allowed by the Regulation which, through

[29] As settled by the ECJ: see *Overseas Union Insurance Ltd and Deutsche Ruck Uk Reinsurance Ltd and Pine Top Insurance Company Ltd v. New Hampshire Insurance Company*, Case C-351/89, 27.06.1991, *ER* 1991, p. I-03317; *Erich Gasser GmbH v MISAT Srl*, Case C-116/02, 9.12.2003, *ER* 2003, p. I-14693.

[30] This happened in the ECJ case *Erich Gasser GmbH v MISAT Srl*, *cit.*, p. I-14693.

the delay created in the resolution of the dispute, benefited the party that disregarded the exclusive election agreement.

This problem had a solution when the Regulation was recast. Now, in accordance with Article 31, Section 2, of Brussels I *bis* Regulation, in a situation of *lis pendens*, where a court of a Member State on which an agreement as referred to in Article 25 confers exclusive jurisdiction is seized, any court of another Member State shall stay for the proceedings until such time as the court seized on the basis of the agreement declares that it has no jurisdiction under the agreement. This rules establishes the priority of the court designated by the exclusive choice-of-court agreement, clarifying Recital 22 "(...) that, in such a situation, the designated court has priority to decide on the validity of the agreement and on the extent to which the agreement applies to the dispute pending before it. The designated court should be able to proceed irrespective of whether the non-designated court has already decided on the stay of proceedings". The aim is to avoid delay of procedural tactic which was facilitated by the previous version of Brussels I, at least in situations where there is an exclusive choice-of-forum agreement[31]. As a consequence, the effectiveness of the choice-of-court agreements is strengthened.

If the court designated in the agreement has established jurisdiction in accordance with the agreement, any court of another Member State shall decline jurisdiction in favor of that court (Article 31, Section 3). The exception to this rule will be the matters referred to in Sections 3, 4 or 5 where the policyholder, the insured, a beneficiary of the insurance contract, the injured party, the consumer or the employee is the claimant and the agreement is not valid under a provision contained within those Sections (Article 31, Section 4). This safeguard is intended to protect the weaker party by permitting in this type of contracts and when the protected party is the claimant that the court first sued, it can declare the invalidity of the agreement of jurisdiction, in accordance with the special rules applicable to these contracts, and retake the rule of priority of the court first seized to establish jurisdiction (Article 29, Section 1).

[31] The non-exclusive choice-of-court agreements are subject to the rule of priority of the court first seized to establish its jurisdiction (Article 29, Section 1), which is justified because the agreement of the parties does not exclude the jurisdiction of other courts.

3. Choice-of-court by submission

Article 26, Section 1, establishes a tacit choice-of-court agreement. When the claim is brought into the courts of a Member State that does not have jurisdiction according to the jurisdiction rules of the Regulation, but before which a defendant enters an appearance, it is considered that a court before which the defendant entered an appearance shall have jurisdiction. This is a choice-of-court by submission allowed by Article 26, except if the objective of that appearance is to challenge the jurisdiction of the court or if there is exclusive jurisdiction granted to another court by virtue of Article 24.

The advantages of submission by the defendant are, in a certain measure, equivalent to those of the choice-of-court agreement. The defendant may decide to accept the court chosen by the claimant, taking into consideration: the law applicable by that court; the coincidence *forum-ius*; easiest production of proof; proximity of the court with the litigation; speed in resolving a dispute; the possibility of concentrating related disputes in the courts of the same State...

One of the difficulties posed by this provision is the concept of enter an appearance. Enter an appearance means that, according to the law of the forum, the defendant enters an appearance to make a submission on the substance of the case. In doing so, the defendant is tacitly accepting the jurisdiction chosen by the claimant. The exception is if the defendant enters an appearance to contest the jurisdiction of the court seized or if there is another court that has exclusive jurisdiction by virtue of Article 24.

About the contest of the jurisdiction of the court seized, the ECJ has stated that the challenge to jurisdiction may not occur after the making of the submissions which under national procedural law are considered to be the first defense addressed to the court seized[32]. However, deciding when the defendant makes submissions on both the jurisdiction of the court and the substance of the dispute is a question that remains. If the defendant contests the jurisdiction of

[32] ECJ, *Cartier parfums – lunettes SAS, Axa Corporate Solutions assurances SA v Ziegler France SA, Montgomery Transports SARL, Inko Trade s. r. o., Jaroslav Matěja, Groupama Transport*, Case C-1/13, 27.02.2014, ECLI:EU:C:2014:109, § 36; ECJ, *Elefanten Schuh GmbH v Pierre Jacqmain*, Case 150/80, 24.06.1981, ECR 1981, p. 01671, § 17; ECJ, *Goldbet Sportwetten GmbH v Massimo Sperindeo*, Case C-144/12, 13.06.2013, ECLI:EU:C:2013:393, § 37.

the court, but makes a subsidiary defense on the substance of the dispute, it is considered that there is no submission. However, according to the ECJ jurisprudence, it is so only if the applicant and the court seized of the matter are able to ascertain from the time of the defendant's first defense that it is intended to contest the jurisdiction of the court[33]. This means that Article 26 allows the defendant contest the jurisdiction, but to submit at the same time a subsidiary defense on the substance of the action: if the defense on the substance is subsidiary, it will be considered that the defendant contested the jurisdiction, and that there was no acceptance of the court chosen by the claimant.

It is possible to question if at least one of the parties should have domicile in a Member State because the wording of Article 26 does not clarify this problem. I agree that the interpretation of Article 26 must be done in accordance with Article 25[34], standing by a systematic interpretation of both rules that are in the same section of the Regulation and refer both to the prorogation of jurisdiction: Article 25, to an express prorogation of jurisdiction; Article 26, to an implicit prorogation of jurisdiction. Consequently, Article 26 should be applied regardless the parties´ domicile, in articulation of the wording of Article 25.

Finally, in Article 26, Section 2, it is possible to find a guarantee for the protection of the weaker party in the contract. The rule states that in matters referred to in Sections 3, 4 or 5 where the policyholder, the insured, a beneficiary of the insurance contract, the injured party, the consumer or the employee is the defendant, the court shall, before assuming jurisdiction under paragraph 1, ensure that the defendant is informed of his/her right to contest the jurisdiction of the court and of the consequences of entering or not entering an appearance. This is a way of ensuring that if the defendant is the weaker party, he/she is informed about all the consequences of a decision when he/she decides to enter an appearance.

[33] *V.g.*, ECJ, *Cartier parfums – lunettes SAS, cit.*, §37 ; ECJ, *Elefanten Schuh GmbH, cit.*, § 14-15; ECJ, *Goldbet Sportwetten GmbH*, *cit.*, 38; ECJ, *Établissements Rohr Société anonyme y Dina Ossberger*, Case C-27/81, 21.10.1981, § 8.

[34] ALFONSO-LUIS CALVO CARAVACA, JAVIER CARRASCOSA GONZÁLEZ, «Article 26», *ECPIL, European Commentaries on Private International Law, Brussels I bis Regulation*, edited by Ulrich Magnus and Peter Mankowski, OttoSchmidt, Köln, 2016, p. 681.

4. Conclusion

The prorogation of jurisdiction is of capital importance in international trade. As stated before, the European Commission has identified that 70% of European companies selling products or providing services on the European market use choice-of-court agreements in international contracts, which draws attention to the importance of the choice of forum agreements in international trade[35]. This led the European Union to carefully regulate the choice-of-court agreements, envisaging them as an instrument of development of international trade in European territory.

However, looking at the legal framework of the Brussels I *bis* Regulation concerning the choice-of-court agreements, there is an obvious flaw. In spite of all the precautions to guarantee the exercise of the autonomy of the parties and to guarantee the establishment of substantial and formal requirements to safeguard a real consensus of the parties, the Regulation does not assure the compliance of the will of the parties or of the legal guarantees that it establishes. In other words, it is not possible to find in the Regulation a sanction for the non-compliance of a court with a jurisdiction agreement or with the legal framework of Article 25. If a court considers that has jurisdiction, notwithstanding the existence of a choice-of-court agreement granting jurisdiction to another court, or a court considers that has jurisdiction as a result of a choice-of-court agreement that does not respect the formal and substantive requirements of Article 25, there are no consequences. This judgment will be recognized and enforced in all Member States under the system of the Regulation.

Article 45 establishes the grounds for the refusal of recognition and enforcements, and the disrespect of a court-of-choice agreement or the requirements of Article 25 by the court of origin are not listed. Additionally, according to Article 45, Section 3, the jurisdiction of the court of origin may not be reviewed. As a consequence, according to Article 36 and Article 39, this judgment

[35] EUROPEAN COMMISSION, *Commission Staff Working Paper Impact Assessment, Accompanying document to the Proposal for a Regulation of the European Parliament and of the Council on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (Recast)*, SEC (2010) 1547 final, Brussels, 14.12.2010, p. 29.

shall be recognized and enforced in accordance with the system of automatic recognition and enforcement of the Regulation, forfeiting any control.

In what concerns the choice of court by submission, it is possible to also find a flaw in the system laid down by the Regulation. In the assumption that the seized court does not comply with the obligation of informing the weaker party, set out in Article 26, Section 2, of its right to contest the jurisdiction and about the consequences of its appearance, the jurisdiction should not be implicitly established according to Article 26, Section 1[36]. However, if the court seized considers that the defendant enters an appearance and judges the case despite the lack of information, there will be a problem because it seems that there is no ground for the refusal of the recognition and enforcement of the judgment[37], according to the ECJ decision in *Česká podnikatelská pojišťovna as, Vienna Insurance Group v Michal Bilas*[38]. In the case where there was an insurance contract and the ECJ considered that, even if the rules of jurisdiction related to the insurance contracts were not complied with, the court seised must declare itself to have jurisdiction if the defendant enters an appearance and does not contest that court's jurisdiction. Entering an appearance in this way amounts to a tacit prorogation of jurisdiction[39]. As a consequence, in this case, the non-recognition rules established in Article 45, Section 1 (e) will not apply, since the defendant entered an appearance and did not contest the court's jurisdiction, so this court acquires jurisdiction according to Article 26, even if the rules that were overridden were special jurisdiction rules[40]. This is a major flaw of the Regulation concerning the prorogation of jurisdiction, and a more serious flaw, because this result jeopardizes the protection of the weaker party laid down by the Regulation, which is one of its main structural principles, as established in Recital 18. The autonomy of the parties in the version of the choice-of-court agreement is limited in the contract of insurance, consumer or employment, to protect the

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[36] ARNAUD NUYTS, «La refonte du règlement Bruxelles I», *RCDIP*, 2013 (1), p. 60; ALFONSO-LUIS CALVO CARAVACA, JAVIER CARRASCOSA GONZÁLEZ, «Article 26», *cit.*, p. 682.

[37] As correctly pointed out by ALFONSO-LUIS CALVO CARAVACA, JAVIER CARRASCOSA GONZÁLEZ, «Article 26», *cit.*, p. 682.

[38] Case C-111/09, 20.05.2010, ECLI:EU:C:2010:290.

[39] *Idem*, *ibidem*, § 33.

[40] *Idem*, *ibidem*, § 33.

weaker party (Recital 19).This protection is clarified in Article 45, Section 1 (e), by allowing the refusal of recognition and enforcement of a decision that breached the special rules of jurisdiction established to protect the weaker party (set in Sections 3, 4 or 5 of Chapter II) where the policyholder, the insured, a beneficiary of the insurance contract, the injured party, the consumer or the employee was the defendant. In contrast, the autonomy of the parties in the version of the choice-of-court by submission breaks this scheme of protection of the weaker party in the case of insufficient information in matters referred to in Sections 3, 4 or 5, since according to the ECJ jurisdiction, the court seized acquires jurisdiction by Article 26. Consequently, its decision will be automatically recognized and enforced under the Brussels I *bis* Regulation system.

An Overview of European Tax Law and Its Impact on European Member-States' Legal Systems: the Portuguese Example

*João Sérgio Ribeiro**

Introduction

This article examines both the scope of European tax law and its impact on European Union Member States' tax systems, using the Portuguese legal system as an example. Any other European Member-State legal system could be used as an example, since the impact of European Tax Law is produced exactly the same way as any of those systems. However, because the author is Portuguese and wishes to give a very brief introduction to taxes that are collected in his own country, the choices made are justified. Even though special attention will be devoted to the Portuguese system, the discussion also applies to other European Union Member-States. The opposite is also true, in that the references made to the Court of Justice of the European Union (CJEU) decisions involving other European Union Member-States, also apply to the Portuguese legal system.

We will start by delimiting the scope of European Tax Law. Subsequently, the Portuguese tax legal system will be briefly described to show how much of it is influenced by the European Tax Law developments. In a later stage, we will select direct taxation as the context for further exemplifying how European Law impacts domestic legal systems. Finally, we will discuss the *Brisal* case as a controversial example of how European Tax Law impacts the Portuguese Corporate Tax Code.

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* Professor of Portuguese, European and International Tax Law at the School of Law of University of Minho, Braga, Portugal.

The author can be contacted at *jribeiro@direito.uminho.pt*.

1. Scope of the EU Tax Law

We could be led to assume that in the same way domestic tax law looks at domestic taxes, EU tax law would focus on European taxes. The scope of this branch of law is much wider though, going far beyond the limits of European taxes. There are two reasons for this.

First, strictly European Taxes are very few and, in addition, their importance in terms of revenue obtained for the EU budget is minimal.

European taxes are restricted to the taxes imposed on the European Union officials, the common customs tariffs, and the sugar production duties. Please note that although VAT is often portrayed as a European tax, it is solely a harmonised tax. Even if part of its generated revenue is transferred to the EU, it is still a national tax imposed by the tax administrations of each of the Member-States.

The tax on officials is a progressive tax (with rates between 8% and 45%[1]) charged by the EU, which withholds it monthly in the same way that national companies do.

The common customs tariffs[2], although charged by Member-States, which retain 25% of the revenue to cover administrative costs, is a fully European Tax.

The sugar levies[3] are paid by sugar producers to compensate for the subsidies they have.

The already modest importance of these taxes is somewhat exacerbated by them being used more for interventionist goals, such as full economic integration, rather than purely financial goals. As previously noted, European Taxes, strictly speaking, account for a minimal part of the European Union revenue.

The European Union's own resources are:

- Sugar levies;

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[1] See Council Regulation (EC, Euratom) No 723/2004 of 22 March 2004, Annex 1, Amendment 60.

[2] See Regulation (EU) No 952/2013 of the European Parliament and of the Council of 9 October 2013, laying down the Union Customs Code.

[3] See Council Regulation (EC) No 1260/2001 of 19 June 2001, on the common organisation of the markets in the sugar sector.

- Common customs tariffs;
- A percentage of VAT, calculated according to a common harmonised basis;
- Transfers from Member-States calculated on the basis of the Gross National Income[4].

If we consider how much each of these resources accounts for the global revenue of the EU, using the budget for 2017[5], we can verify that their relevance is quite dim. Sugar levies and common customs tariffs together account only for 15,9% of the global resources; resources related to VAT transfers, 12,3%; transfers from Member-States calculated on the basis of the Gross National Income, 69,6% (which renders these resources the most relevant), and other resources 2%.

These facts corroborate the initial statement that European taxes are not only scarce, but also of very little relevance in terms of revenue. This also explains why the scope of EU Tax Law is wider than these particular taxes encompassing:

- Indirect taxation harmonisation;
- Direct taxation and the efforts that have been made to achieve some degree of harmonisation;
- Relationship between tax treaties and EU Tax Law;
- Administrative cooperation in the framework of EU Law[6];
- The promising fight against tax avoidance[7].

[4] Gross National income = GDP + (payments received from the rest of the world − payments made to the rest of the world).

[5] According to the data retrieved from the European Union's general budget for the financial year 2017/292/EU, EURATOM, of 28 February 2017.

[6] See Directive 2011/16/EU of 15 February 2011, on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, and Directive 2010/24/EU of 16 March 2010, concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures.

[7] See Directive (EU) 2016/1164 of 12 July 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

2. Portuguese Tax Legal System

In this section we will introduce the main Portuguese taxes and then show how they are influenced by European Tax Law.

2.1. *Main Portuguese Taxes*

a) Corporate Income Tax (IRC)

Corporate income tax is imposed on corporations' and other related entities' incomes. The standard tax rate is 21%. Resident entities are liable to the worldwide income from both domestic and foreign sources, whereas non-resident entities may be liable to be taxed solely on incomes of Portuguese sources.

b) Individual Income Tax (IRS)

Individual Income Tax is imposed yearly on both residents and non-residents who derive income from Portugal, as long as that income is included in the following categories: A – Earned income from dependent employment; B – Business and professional income; F – Real estate income; G – Increases in wealth (including capital gains); and H – Pensions.

Residents are taxed on worldwide income, while non-residents are taxed on Portuguese-sourced income. For residents, the tax rate is progressive, ranging from 14.5% to 48%.

c) Consumption Taxes

Consumption taxes include Valued Added Tax (IVA) and Excises.

Valued Added Tax is a general tax on the consumption of goods and services that is levied at all stages of the economic circuit, from the importer or the producer up to the final consumer. The standard rate is 23%. Special VAT rates are available at 13% and 6%. The 13% applies to restaurant services, canned food, fuel, coloured oil and entries into cultural performances and competitions. The 6% rate applies to basic foodstuffs, books and newspapers, passenger transport, hotel accommodation, medicine and medical equipment.

Excises comprise of duties on alcohol and alcoholic beverages (IABA), tobacco (IT) and energy (ISP).

d) Property Transfer Tax (IMT)

The property transfer tax is levied on the transfer for consideration of ownership rights on real estate (immovable property) situated on Portuguese territory. Property transfer tax rate ranges from 1% to 8% and is payable by the purchaser, that is, the person to whom immovable property is transferred.

e) The Municipal Tax on Real Property (IMI)

The municipal tax on real property is levied on the taxable net-worth value of real property classified as rural or urban property situated within Portuguese territory. The taxable person is the owner, the building lease holder or the person entitled to the use or fruition of the immovable property. Tax rate ranges from 0.3% to o.8%.

f) Stamp Duty (IS)

Stamp Duty is imposed on any deeds, contracts, documents, securities, books, papers, gifts, inheritances and other events described in the Stamp Duty Code. Tax rates range from 0.04% to 25%.

g) Other Taxes

Other taxes include the Motor Vehicle Tax (ISV), the Single Road Tax (IUC), as well as Municipal and State Corporate taxes, just to name the most important ones.

2.2. *How Portuguese Taxes Relate to European Tax Law*

None of the taxes listed above, although in a different extent, escapes the influence of European Tax Law. We would say that every referenced tax, even those mostly grounded in domestic law – such as property taxes (property transfer tax, the municipal tax on real property), stamp duties tax and *other taxes* –

cannot infringe on fundamental economic freedoms (which we will analyse briefly in the next section).

The other taxes alluded to, which are the most important in terms of revenue, are directly shaped by European Tax Law.

As we have already mentioned, indirect taxes, such as VAT and excises, are the best examples of how European Union Law can shape domestic taxes, to the extent that they are fully harmonised. As a consequence, their base is the same throughout Europe, varying only in the tax rates applied.

VAT is, indeed, one of the oldest examples of tax harmonisation in Europe. It has been in force in Portugal since January 1st, 1986. Most of its legal regime is based on the Council Directive 77/388/EEC of 17 May 1977 (usually referred to as the "Sixth Directive"), which established the common system of valued added tax in the Member-States of the European Union (EU). Meanwhile, other directives have been modelling this important harmonised tax.

Even other important taxes such as Corporate and Individual income taxes have been heavily influenced by the CJEU. This influence often leads to changes of these income tax provisions to accommodate the decisions of the CJEU. Some harmonisation already exists within corporate income tax, not only by the action of the CJEU, which, as said, has been imposing changes in the provisions of the corporate tax code, but also by some directives whose implementation often implies that those directives themselves are converted into part of the corporate tax code. Let's take a look at some of those directives, which are now part of the Portuguese tax legal system as well as other European Union Member-States' legal systems.

The Parent-Subsidiary Directive[8] deals with the elimination of economic double taxation arising within a group of companies from a cross-border distribution of profits. It provides, under certain conditions, an exemption from the withholding tax in the state of the subsidiary, as well as the obligation for the state of the parent company to eliminate economic double taxation. It relieves the two layers of tax levied in the hands of the parent upon the distribution of

[8] Council Directive 2011/96/EU of November 2011, on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member-States and subsequent amendments.

profits. These layers include the withholding tax in the state of the subsidiary and the corporate tax levied in the hands of the parent upon the profits so received in the state of residence.

The Merger Directive[9] is a reaction to how, in the absence of any specific tax provisions, reorganizations would generally trigger taxation of unrealized capital gains, which hinders the completion of an internal market within the European Union. It is, therefore, necessary to introduce tax provisions that make those operations neutral from the tax point of view. Hence, the essence of the Merger Directive is the deferral of capital gains tax on the occasion of a qualifying reorganization covered by the Directive. The Directive requires Member-States to refrain from taxing any capital gains triggered by the cross-border merger (partial division), transfer of assets and exchange of shares.

The Interest and Royalty Directive[10] is based on the notion that in the single market, interest and royalty payments between associated companies of different Member-States should not be subject to less favourable tax conditions than those applicable to the same payments carried out between associated companies of the same Member-State. The main consequence of the Directive is the exemption from source state tax on interest and royalty payments made by a company of a Member-State or by a permanent establishment (situated in another Member-State) of a company of a Member-State. This occurs provided that the beneficial owner of the interest or royalty payments is an associated company of another Member-State or a permanent establishment situated in another Member-State of an associated company of a Member-State.

There is also a very promising development that can take harmonisation in the field of corporate taxation to an unprecedented level. We are referring to the Common Consolidated Corporate Tax Base (CCCTB). This mechanism, em-

[9] Council Directive 2005/19/EC of 17 February 2005, amending Directive 90/434/EEC 1990 on the common systems of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member-States.

[10] Council Directive 2003/49/EC of 3 June 2003, on common system of taxation applicable to interest and royalty payments made between associated companies of different Member-States.

bodied in two proposal directives,[11] aims at solving one of the most serious problems that multinationals operating in more than one Member-States face − severe compliance costs and very likely, a lack of cross-border relief because their activities fall within several tax jurisdictions. To solve this problem, the European Commission has come up with the idea of providing companies with a consolidated corporate tax base for their EU-wide activities. Under this method, a consolidated tax base of a group of companies would be established and, secondly, it would be divided among jurisdictions based on a formula apportionment. This will involve a revolutionary change, switching the methods for income allocation from the arm's length method to a formula apportionment method. The formula is a multiple-part formula that integrates the following factors: labour, assets and sales. If these proposals are implemented, there will be harmonisation in the taxation of large companies or in small or medium companies that opt for this regime.

3. The Relevance of Fundamental Freedoms for Direct Taxation

In this section, we will explain why we select direct taxation to exemplify the impact of European Tax Law on domestic law and the role played by the protection of fundamental economic freedoms. By discussing this, we hope to give readers a good grasp of European Member-States Tax Legal Systems, since the issues addressed are common among all of them.

3.1. *Reasons that Can Justify a Special Focus on Direct Taxation*

From the several topics that helped us to delimit the scope of the EU tax law, we will be concentrating on direct taxation.

We chose to address the issues that relate to Direct Taxation because that is the context in which the influence of EU Law is most peculiar and still evolving (which will allow us to understand what phases normally precede a full

[11] COM(2016) 685 final of 25 October of 2016, Proposal for a Council Directive on a Common Corporate Tax Base and COM(2016) 683 final of 25 October of 2016, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB).

harmonisation such as the one in place in the field of indirect taxation). Moreover, direct taxation is also the field where the main obstacles to the development of the internal market are most apparent. In addition, the most promising developments are also most likely to occur in that field.

Before engaging in the study of direct taxation, let us go through the different areas that can be included in the scope of EU tax law, further demonstrating that direct taxation itself is the most suitable topic for the analysis at hand.

In the field of European Taxes, strictly speaking, there is not much we can discuss apart from the technicalities of each of the taxes. The influence they have on domestic tax laws is minimal. It simply implies that Member-States refrain from creating their own customs tariffs, sugar levies and taxes on officials.

With respect to indirect taxation, the influences were very relevant in the past, but, at the moment, harmonisation is already very advanced. Therefore, no particularly interesting issues arise. The CJEU's decisions in this field are normally very technical, having not the fundamental freedoms or EU principles, but Indirect Tax directives as a basis. At the end of the day, there is no conflict between EU Member-States' law and EU law, but there is a difference in viewpoint on EU Law. Please note that VAT and excises codes are harmonised[12].

The influence of the EU Law is much more important in the field of direct taxation, which can be explained by the absence of detailed rules addressing tax issues. Thus, as we observed, direct taxes are only harmonized in very limited areas. The lack of full harmonisation implies that the CJEU is required to play a particularly important role whenever internal laws infringe on European Law. As a result, the issues analysed by the CJEU are not European Tax Law *tout court*, as it happens in the field of indirect taxation, but European Law. The CJEU simply determines if tax law complies with the principles of EU Law.

As previously stated, harmonisation is still under construction and progress has been made in a very peculiar way. It has been made by the court's

[12] Cfr. Directive 2006/112/EC of 28 November 2006 (and subsequent amendments), on the common system of value added tax and Directive 2008/118/EC of 16 December 2008, concerning the general arrangements for excise duty.

dodging of the unanimity requirement (among Member-States' ministers of finance – ECOFIN) and represents a "harmonisation through the back door".

All of these features make direct taxation the most interesting topic to address in the context of EU Tax Law, allowing us to understand how harmonisation really evolves.

The relationship between EU Tax Law and tax treaties is also part of the contents of EU Tax Law. This topic is very interesting, but it calls for a previous study of not only EU Law but also of tax treaties, which renders it unsuitable for the overview we would like to give on the impact of European Tax Law.

The scope of European law also encompasses the exchange of information and cross-border cooperation between tax authorities. These instruments complete domestic law and, therefore, do not conflict with it, which render those cooperation instruments not very controversial. The same can be said about the fight against tax avoidance. In both cases, directives regulating those matters have to be implemented and, therefore, transformed into domestic tax law.

As a summary, we can say that direct taxes are the right arena to follow the most relevant developments in terms of European Taxation.

Direct taxes being the last bastion of a fading fiscal sovereignty adds to the importance of these issues.

Tax sovereignty is no longer the same, as exemplified through the ever present interference by the CJEU and the fiscal measures imposed onto Member-States (Portugal is a good example). This is what makes direct taxation issues so important. The sovereignty, albeit feeble, that they still entail has great symbolic value since it represents the thin red line that separates the Union from a true Federation. For the Union to become a Federation, there are only two features missing: (i) Power of EU Institutions to change the treaties (Member-States remain masters of the treaties); (ii) and tax spending capacity (Fiscal Federalism).

At the end of the day, political union and fiscal sovereignty are linked and depend on each other. James Madison[13] had a very clear view of this rela-

[13] Fourth President of the United States of America, in office from 1809 to 1817.

tionship as can be seen through one of his most famous statements: "Federalize their wallets and their hearts, and their minds will follow".

Thus, one cannot forget that it is in the field of direct taxes that redistribution can be carried out. For the reasons set out, we think there is a strong argument to focus on direct taxation.

3.2. *Direct Taxation – State of the Art*

Although direct taxation covers both the taxation of individuals (natural persons) and the taxation of companies (legal persons), the most relevant and recent developments have occurred in the field of company taxation. In contrast, harmonisation in the field of individual taxation is still frail[14].

Major developments were triggered by the need for minimizing the negative effects of the existence of different company tax legislation throughout Europe, which poses serious dangers to the internal market[15].

The feeble harmonisation that exists is limited, covering only certain areas such as the distribution of dividends between parent and subsidiary companies as well as mergers and payments of interest and royalties between associated companies, just to mention a few examples. This contrasts with what happens in the field of indirect taxation where the harmonisation is sound.

Differences in harmonisation can be explained by how the TEC (Treaty establishing the European Community), in the corresponding provision today to Article 113 of the TFEU, directly addresses harmonisation in the field of indirect taxation, leaving out direct taxation. To make things worse, harmonisation implies unanimity among Member-States.

There are two reasons that are paramount for explaining why the harmonisation of direct taxes is lagging behind. First, after the economic and monetary union was established by the Maastricht Treaty, currency stopped being used as an instrument of financial policy, and states did not want to relinquish the last tools within their reach to implement those policies. Equally important,

[14] See, as an example, case C-279/93, *Schumacker*, of 14 February of 1995.

[15] See articles 3 e 26 of the Treaty on the Functioning of the European Union (TFEU).

Member-States are very reluctant to give up fiscal sovereignty for the symbolic value it has.

We cannot deny that there is an ongoing harmonisation through the back door[16] made by the CJEU. It has been repudiating internal tax law and breaching the fundamental freedoms. However, for the coordination in terms of company taxation to proceed further, we need something better than a sporadic action by the Commission and the CJEU as a response to concrete situations that only produce tax changes as side effects. As a matter of fact, the harmonisation carried out so far has a merely ancillary role in relation to the attainment of the EU economic goals. One has to conclude that the EU does not possess the power to impose tax measures *ab initio* (from the start), that is, to impose a full fiscal sovereignty, but only *de facto*, which, given its growing importance, should be overtly recognized.

It is necessary to create innovative approaches and a policy targeting harmonisation in the field of company taxation directly. This need is mirrored by claims made by European businessmen[17] to move to a unitary taxation of companies, making taxation more[18] efficient and compatible with economic integration. If that does not happen, fundamental freedoms are the most efficient tool to achieve some of the goals of harmonisation.

3.3. *Impact of Fundamental Freedoms*

Even though Member-States have exclusive competence for direct taxation, the CJEU has held in its settled case law that the Member-States must, nonetheless, exercise that power consistently with European Union law and avoid any discrimination on grounds of nationality.

[16] We speak about harmonisation through the back door because, by using the CJEU, it is possible to harmonise tax laws dodging the unanimity requirement.

[17] See SED CREST, «Why European tax executives are under pressure», *International Tax Review*, June 2004, p. 13-20.

[18] Cfr. *European Commission, Report of the Committee of Independent Experts on Company Taxation (Ruding Committee)*, Official Publications of the European Communities, Luxembourg, 1992, p. 211.

European Union Law comprises of five fundamental freedoms: the free movement of goods[19]; the free movement of workers[20]; the freedom of establishment[21]; the freedom to provide services[22]; and the free movement of capital[23]. Even if the last four fundamental freedoms have an impact on direct taxation, all the freedoms are directly applicable. As a result, if the national legislation of a Member-State infringes on the fundamental freedoms, that Member-State must refrain from applying the discriminatory legislation.

To determine whether a national provision represents an obstacle to the European Union, that is, if it does not comply with fundamental freedoms, courts may ask the CJEU for a preliminary ruling[24]. In addition to the preliminary reference of national courts, the Commission has the option of starting an infringement procedure against the Member-State if it considers its national legislation to infringe on European Union Law[25].

Let us now look at the freedoms that impact direct taxation.

3.3.1. Free Movement of Workers

Any discrimination based on the nationality between workers of the Member-States must be abolished. This comprises of employment, remuneration and other conditions for work and employment. According to the case law, the essential feature of the employment relationship is that, for a certain period of time, a person performs services (for and under the direction of another person) in return for remuneration[26].

Based on the fact that domestic provisions on income tax are covered by the principle of non-discrimination, the CJEU has held that the principle of

[19] See articles 28 *et seq.* of the TFEU.
[20] See articles 45 *et seq*. of the TFEU.
[21] See articles 49 *et seq*. of the TFEU.
[22] See articles 56 *et seq*. of the TFEU.
[23] See articles 63 *et seq*. of the TFEU.
[24] See article 267 of the TFEU.
[25] See articles 258-260 of the TFEU.
[26] See case C-66/85, *Lawrie-Blum*, of 3 July of 1986.

equal treatment regarding remuneration would be rendered ineffective if it could be undermined by discriminatory national provisions on income tax[27].

3.3.2. Freedom of Establishment

Freedom of establishment is comprised of the right of individuals to take up or pursue activities as self-employed persons in another Member-State as well as the right to set up and manage undertakings in another Member-State[28].

This fundamental freedom also applies to companies, and it grants them the right to set up agencies, branches or subsidiaries in another Member-State. Whether a person or a company that acquires participation in a company established in another Member-State exercises the freedom of establishment depends on the extent to which he/she/it may influence and control the foreign company.

In the *Baars* case[29], the CJEU decided that a holding in the capital of a company established in another Member-State, giving the shareholder a definitive influence over the company's decisions and allowing him/her or it (if the shareholder is also a company) to determine the company's activities, corresponds to the exercise of the right of establishment. In subsequent cases, this principle was confirmed and applied in concrete situations[30].

3.3.3. Freedom to Provide Services

Freedom to provide services prohibits any discrimination of nationals of a Member-State in providing services in another Member-State. The Treaty on the Functioning of the European Union provides that services include: a) Activi-

[27] See case C-279/93, *Schumacker*, of 14 February of 1995.

[28] See C-314/08, *Filipiak*, of 19 November of 2009; C-96/08, *Ciba*, of 15 April 2010.

[29] C-251/98, of 13 April of 2000.

[30] See C-196/04, *Cadburry Schweppes*, of 12 September 2006 and C-524/04, *Thin Cap Group Litigation*, of 13 March of 2007. In these cases, the CJEU decided that the British thin capitalization rules fall within the freedom of establishment in the sense they implied a qualified participation was held in a foreign company that provided a definitive influence.

ties of an industrial character; b) Activities of a commercial character; c) Activities of craftsmen; and d) Activities of the professions[31].

It is not always easy to distinguish freedom to provide services from freedom of establishment. The main difference is that the former, in contrast with the latter, is random, sporadic and impermanent[32].

3.3.4. Free Movement of Capital

Free movement of capital provides that all restrictions on the movement of capital and payments between Member-States and third countries are prohibited. This fundamental freedom is the only one that applies both within the community and *vis-à-vis* third states.

There is no definition for the term "movement of capital" in the Treaty, but the CJEU has stated that "in the absence of a Treaty definition of 'movement of capital' within the meaning of Article 56(1) EC [currently Article 63 of TFEU], the Court has acknowledged the indicative value of the nomenclature of movements of capital set out in Annex I to Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the [EC] Treaty (article repealed by the Treaty of Amsterdam) (OJ 1988 L 178, p. 5). Thus, the Court has held that movements of capital within the meaning of Article 56(1) EC [currently article 63 of TFEU] include in particular 'direct' investments, namely investments in the form of participation in an undertaking through the holding of shares which confers the possibility of effectively participating in its management and control, and 'portfolio' investments, namely investments in the form of the acquisition of shares on the capital market solely with the intention of making a financial investment without any intention to influence the management and control of the undertaking"[33].

[31] See C-56/09, *Zanotti*, of 20 May of 2010; C-105/08, *European Commission v. Portuguese Republic*, of 17 of June of 2010; C-498/10, *X*, of 18 of October of 2012.

[32] To make a clear distinction between the two freedoms see C-55/94, *Reinhard Gebhard*, of 30 November of 1995.

[33] *In* C-171/08, *European Commission v. Portuguese Republic*, 8 of July of 2010, no. 49.

3.3.5. Justifications For Restriction and Infringement

Even if fundamental economic freedoms are infringed on, States may justify such violations. Some justifications are accepted while others are normally rejected.

a) Accepted Justifications

A violation of fundamental freedoms can be justified by the need to protect public interest. Based on that argument, some justifications commonly referred to suggestively as designations outside the catalog have been put forward, namely (i) the coherence of the tax system, (ii) territoriality , (iii) the idea of anti-abuse, and (iv) the effectiveness of fiscal supervision. These justifications always have to be harmonised with the principle of proportionality, which serves as an insurmountable threshold that should always be considered. This translates into the idea that one should not go beyond what is necessary to achieve a certain goal. Thus, to achieve a certain goal, Member-States should choose the least discriminatory measure among the ones available.

b) Unaccepted Justifications

Even though the justifications mentioned above have been accepted by the CJEU, there are others, however, which have always been clearly rejected, such as (i) the lack of harmonisation in the area of direct taxes, (ii) the difficulty in obtaining information, (iii) the loss of tax revenue and (iv) the compensation of the unfavourable treatment with other advantages.

4. Conclusion: *Brisal* Case Study

To conclude this brief overview, we will now show how the protection of fundamental freedoms – in the case at hand, the freedom of establishment – impacts the Portuguese tax legal system, and, thereby, other EU systems, by using the *Brisal* decision. After sharing the arguments of the CJEU, we will close this article with some critical remarks on its approach.

4.1. *Summary of the Case*

The case to be analyzed is a good example of how the protection of the freedom of establishment can imply changes in national laws, even if there is a strong case against the arguments put forward by the CJEU to sustain the decision.

On 13 July 2016, the CJEU delivered its decision in *Brisal*[34] in response to the questions referred to it by the Portuguese Supreme Court. The main issue relates to the application of Portuguese corporate tax to interest derived by an Irish financial institution in Portugal.

Brisal – Auto Estradas do Litoral SA (Brisal), established in Portugal, and KBC Finance Ireland, a bank established in Ireland, entered a financing agreement. In the context of this contract, *Brisal* paid interest to KBC and withheld corporate tax at the source. Both *Brisal* and KBC claimed that non-resident financial institutions are subject to a heavier tax burden than resident financial institutions, contrary to the freedom to provide services and the free movement of capital, as set out in Articles 56 and 63 of TFEU. As a result, they requested that the costs of financing the loans be granted, as well as expenses directly related to the economic activity carried out be taken into account in the source state.

The Portuguese Supreme Administrative Court decided to stay for the proceedings and refer the following questions to the CJEU for a preliminary ruling:

(1) "Does Article 56 TFEU preclude national tax legislation under which financial institutions not resident in Portuguese territory are subject to tax on interest income received in that territory, withheld at source at the definitive rate of 20% (or at a lower rate if there is an agreement to avoid double taxation), a tax applied to gross income with no possibility of deducting business expenses directly related to the financial activity carried out, whereas the interest received by resident financial institutions is incorporated in the total taxable income, with deduction of any expenses related to the activity pursued when de-

[34] C-18/15, *Brisal and KBC Finance Ireland*, of 13 July of 2016.

termining the profit for the purposes of [IRC], so that the basic rate of 25% is applied to the net interest income?

(2) Does the same hold true even if the tax base of resident financial institutions, after deduction of the financing costs related to the interest income, or of expenses directly related, economically, to such income, is or may be subject to a higher tax than is deducted at source from the gross income of non-resident institutions?

(3) For this purpose, can the financing costs associated with the loans granted, or the expenses directly related, economically, to the interest income received, be proved by the data provided by the Euribor (Euro Interbank Offered Rate) and by the Libor (London Interbank Offered Rate), which represent the average interest rates charged on interbank financing used by banks to carry out their activity?"[35]

The CJEU gave the following answers:

(1) "Article 49 EC [currently Article 56 of TFEU] does not preclude national legislation under which a procedure for withholding tax at source is applied to the income of financial institutions that are not resident in the Member-State in which the services are provided, whereas the income received by financial institutions that are resident in that Member-State is not subject to such withholding tax, provided that the application of the withholding tax to the non-resident financial institutions is justified by an overriding reason in the general interest and does not go beyond what is necessary to attain the objective pursued;

(2) Article 49 EC [currently Article 56 of TFEU] precludes national legislation, such as that at issue in the main proceedings, which, as a general rule, taxes non-resident financial institutions on the interest income received within the Member-State concerned without giving them the opportunity to deduct business expenses directly related to the activity in question, whereas such an opportunity is given to resident financial institutions;

[35] *In Brisal and KBC Finance Ireland*, *cit.*, no. 16.

(3) It is for the national court to assess, on the basis of its national law, which business expenses may be regarded as being directly related to the activity in question"[36].

4.2. *Critical Remarks*

Brisal is a good example of how harmonising taxation through the back door might jeopardize some of the cornerstones of the EU edifice, namely the essential tax sovereignty of Member-States, in the absence of which, there would be no resources to fund the European Union. This issue is particularly significant in the current context, which is characterised by an international movement that goes beyond the fight against tax evasion and places the focus on something that was, until recently, accepted – tax base erosion and profit shifting. It is hard to believe that the CJEU is unaware of the impact of this decision, which will impose a heavy burden of proof on many non-residents who, if taxation of net income at source becomes the rule, will probably argue that such a manner of taxing non-residents is discriminatory and contrary to free movement. Since taxation based on net income is seen as merely an option and not as a mandatory one, this means that the discrimination argument cannot be invoked. Moreover, forcing source states to grant non-residents the possibility of deducting expenses, while not impossible, is not a realistic proposal considering the administrative burden it implies. The number and type of transactions in which a non-resident engages are many, numbering sometimes into the thousands; a great deal of such transactions are modest and have an extremely weak connection to the source state.

It seems that, in reality, the CJEU has an agenda – to discourage source states from taxing such income. This is because the alternative – continuing to tax such income, allowing for expense deductions – is too complex to implement.

[36] *In Brisal and KBC Finance Ireland*, *cit.*, no. 55.

Reforming China's Foreign Tax Credit with a Liberal Approach in the "One Belt, One Road" Era

Yi Zheng *

I. Foreign Tax Credit and Its Two Normative Objectives

A. *International Double Taxation and Foreign Tax Credit*

By the end of the 19th century, all major western countries had gone through industrialization, entering the age of capital exportation. The first thirty years of the 20th Century witnessed the global integration through the frequent flow of capital. The increasing flow of capital and business transactions between countries bring in tremendous income outside one country's territory, and that income is subject to taxes of more than one country, although each country is acting within the prescription of customary international law. Tax jurisdictions are based on a variety of factors which include: nationality, domicile or residence, presence, locations of property, business activities or income. In fact, these bases underlie two fundamental jurisdictions of international taxation: resident (worldwide) jurisdiction and territorial (source) jurisdiction. Resident jurisdiction prescribes that activities, interest, status or relations of a country's residents outside as well as within its territory are covered by that country, meaning that a person's worldwide income would be defined and taxed in his/her country of residence[1]. The location where income is derived is another

* Sun Yat-sen University, School of Law; Research Fellow; Washington University in St. Louis, School of Law; Juris Scientiae Doctoris (J.S.D.), 2017; Master of Laws in Intellectual Property Law, Class of 2014; Sun Yat-sen University, School of Law; Bachelor of Laws, Class of 2013; Practicing lawyer of People's Republic of China, 2013.

[1] For example, according to Article 1 of the *Individual Income Tax Law of the People's Republic of China*, individuals that meet a certain standard are subject to China's tax jurisdiction on their worldwide income. It prescribes that "an individual who has a domicile in the territory of China or who has no domicile but has stayed in the territory of China for one year or more shall pay individ-

factor for exercising a country's tax power; this is known as territorial (source) jurisdiction. This jurisdiction covers conduct that wholly or substantially, takes place within a country's territory, and is limited within its border regardless of the deriver of income[2].

Virtually all countries in the world excise both resident and territorial jurisdictions; it is obvious that fully exercising in both these jurisdictions will lead to international double taxation. Harmful effects of double taxation have been recognized by consensus among international society[3]. Few international transactions would occur if taxpayers could not retain enough profits to make the transaction process worthwhile. This result is pernicious because international exchanges of investment, technology, and labor are the foundation for comparative advantages; once international transactions decrease, worldwide welfare will be adversely affected[4]. At the domestic level, double taxation constitutes a sort of "inequity" that favors domestic over international investment[5], and it affects the efficiency of investment, since taxation results may alter business

ual income tax in accordance with the provisions of this Law for his incomes obtained in and/or outside the territory of China." Comparably, the United States taxes the worldwide income of its citizens, regardless of where they reside or are domicile. See Cook v. Tait 265 U.S. 47, 1924.

[2] Countries that adopt source as the primary jurisdiction, like France, believe that the income they have sovereignty to tax comes only from domestic sources regardless of who earns it. See HUGH J. AULT & BRIAN J. ARNOLD, *Comparative Income Taxation: A Structural Analysis*, Kluwer Law International, 2004, p. 379.

[3] For example, in the 2010 OECD Model Tax Convention on Income and on Capital, it shows this consensus in the very beginning of the introduction: "Its (the international juridical double taxation) harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it's scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries". See the introduction of 2010 OECD Model Tax Convention on Income and on Capital, available at *http://www.oecd.org/tax/treaties/47213736.pdf.*

[4] See JULIE ROIN, «Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems», *Va. L. Rev.*, 81, 1995, pp. 1753, 1759.

[5] The "inequity" comes from the deviation of the "ability to pay" principle. Simply stated, tax equity is achieved when taxpayers with equal incomes pay equal amounts of tax. If taxpayers with the same income are treated differently due to the source of income, it will be discrimination and go against the justice requirement of tax law. See ROBERT L. PALMER, «Toward Unilateral Coherence in Determining Jurisdiction to Tax Income», *Harv. Int'l L.J. 1*, 30, 1989, pp. 9-10.

profits, put foreign investment at a disadvantage and distort business decisions[6].

In the 1930s, as a response to the explosion of cross-border transactions and the increasing problems of international double taxation, a basic international taxation system was formed[7]. Relieving international double taxation is one of the central focuses of the system and several methods are provided to do so, including multilateral, bilateral and unilateral ways[8]. Foreign tax credit is a typical unilateral approach. Countries adopting this approach grant "credits" against taxes on a resident taxpayer's worldwide income. In other words, resident countries unilaterally "deduct" the already paid territorial taxes from the ultimate tax liability[9]. If the source country's tax rate is not higher than that of the resident country on the same item of income, the effective overall tax burden after the foreign tax credit will be equal to the tax on the taxpayers' worldwide income. If the foreign jurisdiction has a higher tax rate, the resident countries will collect residual tax, but they will not refund money to taxpayers, to prevent the already paid taxes to a foreign country from offsetting domestic tax bases. Credits are limited to the amount of domestic tax that otherwise would be imposed on a resident taxpayer's foreign source taxable income, and this is

[6] Tax rules are thought to be efficient when the business decision out of tax consideration is as little as possible. DANIEL J. FRISCH, «The Economics of International Tax Policy: Some Old and New Approaches», *Tax Notes*, 47, 1990, pp. 581, 582-87.

[7] See MICHAEL J. GRAETZ & MICHAEL M. O'HEAR, «The "Original Intent" of U.S. International Taxation», *Duke L.J.*, 46, 1997, pp. 1021, 1034 [hereinafter GRAETZ & O'HEAR, «The "Original Intent"...»].

[8] The multilateral approach proposes reaching a unitary conclusion to resolve the international double taxation based on existing consensus. See REUVEN S. AVI-YONAH, «Structure of International Taxation: A Proposal for Simplification», *Tex. L. Rev.*, 74, 1996, p. 1301; the bilateral approach is when tax treaties between countries are used to allocate jurisdictions between source and residential, assuring that the income from cross-border transactions is subject to one and only one jurisdiction. This is also a common practice in the real world. Unilateral approach relies on a country's domestic law to relieve international double taxation. Exempt income outside the country or treat paid taxes as credits to offset domestic liabilities on worldwide income are two the main ways of the unilateral approach.

[9] Notably, it is the final tax liability that is deducted in the foreign tax credit; in contrast, another unilateral approach to relieve international double taxation is to deduct foreign taxes from the worldwide income when calculating the taxable income of the resident country. See KIMBERLY CLAUSING & DANIEL SHAVIRO, «A Burden-Neutral Shift from Foreign Tax Creditability to Deductibility?», *Tax L. Rev.*, 64, 2011, pp. 431, 433.

the foremost limitation of the foreign tax credit[10]. Besides limiting the overall amount of income, to prevent the "blending" of income from different transactions that makes aggressive use of credits, income is characterized, and taxes can only be cross credited within the same category.

The foreign tax credit mitigates international double taxation and reduces or eliminates the differences of after-tax returns between domestic and foreign investments. Aside from relieving double taxation, foreign tax credit is an essential part of a resident country's outbound taxation system. It is closely related to the rules regarding taxpayers' foreign source income, such as source rules, controlled foreign corporation rules, choice of entity rules, etc. Consequently, final tax results of a resident country are determined by foreign tax credit as well as other related rules; the study of a foreign tax credit system should be done through a holistic perspective.

B. *The Sovereign Issue in International Taxation*

Sovereignty is a subject that has been analyzed extensively in international relations literature[11]. A sovereign state is expected to represent the supreme source of authority on internal matters and must also be independently external[12]. Sovereign issues in international taxation is not a recent phenomenon; there are two factors of the "functions" of sovereignty in international taxation.

Revenue collection is the foremost role that taxation plays in a sovereign country. Indeed, the connection between tax revenue and the maintenance of

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[10] See CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, *Taxation of International Transactions: materials, text and problems*, 4th ed., West, 2011, p. 14 [hereinafter GUSTAFSON, PERONI & PUGH, *Taxation of International Transactions...*].

[11] For example, see MICHAEL ROSS FOWLER & JULIE MARIE BUNCK, *Law, Power, and the Sovereign State*, 1995, p. 23; ALAN JAMES, *Sovereign Statehood*, 1986, pp. 177-79.

[12] The "modern" vision of sovereignty emerged in the 1500s: "The concept of exclusive control within a delimited geographic area and the untrammeled right to self-help internationally, which emerged out of late medieval Europe, have come to pervade the modern international system" – STEPHEN D. KRASNER, «Structural Causes and Regime Consequences: Regimes as Intervening Variables», *International Regimes*, 1, 1983, p. 18.

sovereignty is so clear that it is recognized as common sense[13]. The establishment of a suitable environment to live, develop, entertain, conduct business, and receive an education largely depends on public finance; other functions that rely on tax revenue but were not mentioned include nationwide construction of infrastructures and the maintenance of government, courts, police, etc. As the U.S. Supreme Court announced in 1898, "The power to tax is as necessary to the existence and prosperity of a nation as is the air he breathes to the natural man"[14]. Therefore, collecting money and determining the scope, size, and function of the raised money (taxes) are necessary of a sovereign state.

Tax is also linked to fiscal sovereignty, and the second function of tax is to adjust economic activities. Tax is a crucial aspect of a country's fiscal policy as it, to some extent, alters social and economic order. Specifically, taxes can be used to increase or decrease inflation and purchasing power, to stimulate investment, and to prevent harmful concentrations of wealth[15].

In short taxation is an important aspect of sovereignty tied to the core interests of a nation. Transactions of international taxation are usually subject to more than one country's jurisdiction; foreign tax credit of the resident country not only includes legal relations between taxpayers and nations, but it is also relevant to the apportionment of core interests among sovereignties on the international level.

[13] For example, "Taxes are necessary to raise revenue for public goods and infrastructure, as well as to provide other sorts of public services conducive to general welfare and economic growth" – KENNETH L. SOKOLOFF & ERIC M. ZOLT, «Inequality and Taxation: Evidence from the Americas on How Inequality May Influence Tax Institutions», *Tax L. Rev.*, 59, 2006, pp. 167-68; "Taxes are directly tied to legitimacy of any government because governments need a cheap, steady source of revenues to survive" – MARJORIE E. KORNHAUSER, «Legitimacy and the Right of Revolution: The Role of Tax Protests and Anti-Tax Rhetoric in America», *Buff. L. Rev.*, 50, 2002, pp. 819, 882.

[14] See Nicol v. Ames, 173 U.S. 509, 515, 1898.

[15] In fact, the underlying theory for much of these arguments is Keynesian economics. See GEORGE A. NIKOLAIEFF, «The Longest Boom In History», *Taxation and the Economy*, 1968, pp. 11-27.

C. *Foreign Tax Credit in the Real World and its Two Inherent Principles*

In fact, a more serious problem in the real world, as opposed to international double taxation, is "double non-taxation." In other words, cross-border income is undertaxed or (at the extreme instance) is subject to no tax at all[16]. This phenomenon violates the "single tax principle" as the normative principle of international taxation, and it is, thereby, detrimental in several respects[17]. It, in fact, creates a subsidy for foreign-source income, discriminating against taxpayers who only have domestic income; it also alters investment decisions and may lead to hazards of deadweight loss. Moreover, under-taxation goes against the equitable requirement of the normative tax system. It also threatens the overall tax compliance and even the whole revenue gain.

Apart from problems arisen domestically, double non-taxation in the digital economy age, and more specifically, tax base erosion and profits shifting have been worldwide challenges plaguing every sovereign nation[18]. Foreign tax credit is a key element of the outbound international taxation system, as well as an indispensable part of the tax-planning chain of multinational enterprises. Usually, MNEs manipulate source rules and cost allocation rules to foreignize more income than expenses to increase the foreign tax credit limitation and obtain more credits; they also take advantage of cross-crediting rules to reduce the residual tax obligation to the home country. Moreover, with regards to the aggressive tax planning instance, multinational enterprises maneuver the entire outbound international taxation system of resident countries, combining tactics and taking advantage of foreign tax credit along with other aspects like deferral privilege, hybrid entity structures and transfer pricing methods[19]. In every in-

[16] See REUVEN S. AVI-YONAH, «The International Taxation of Electronic Commerce», *Tax L. Rev.*, 52, 1997, pp. 507, 517.

[17] See *Id.*, p. 519.

[18] See, YARIV BRAUNER, «What the BEPS?», Fla. Tax Rev., 16, 2014, p. 55) [hereinafter BRAUNER, «What the BEPS?»]; EDWARD D. KLEINBARD, «Through a Latte, Darkly: Starbucks's Stateless Income Planning», *Tax Notes*, 139, June 24, 2013, p. 1515; «Stateless Income», *Fla. Tax Rev.*, 11, 2011, p. 699 [hereinafter KLEINBARD, «Stateless Income»].

[19] See J. CLIFTON FLEMING JR., ROBERT J. PERONI, & STEPHEN E. SHAY, «Worse Than Exemption», *Emory L.J.*, 59, 2009, p. 79 [hereinafter FLEMING, PERONI & SHAY, «Worse Than Exemption»]; for more aggressive tax planning tactics exploiting tax regimes in different countries

stance, they attempt to minimize the tax obligation, but in turn, these activities sharply erode the tax base of resident countries.

While foreign tax credit fundamentally relieves international double taxation, it also protects the resident country's tax base. A well-designed foreign tax credit system is expected to inherently contain two such crucial aspects.

II. Chinese Foreign Tax Credit: A Defective Regime Yet to Be Improved

The foreign tax credit in China was enacted in 2008, and it was one of the substantial reforms of the Enterprise Income Tax Law of People's Republic of China (EIT). As many commentators have pointed out, China has made significant progress in international taxation law[20]. However, foreign tax credit, as a relatively unfamiliar and inexperienced mechanism to Chinese legislators, executive authority and taxpayers, is defective in two regards. Firstly, current Chinese foreign tax credit rules are restrictive, not effectively relieving international double taxation; secondly, Chinese foreign tax credit rules are general and basic. It lacks specific rules and clear guidance, impeding enterprises from obtaining credits in practice. Presently, the "One Belt, One Road" initiative and the "go global" strategy encourage Chinese enterprises to go abroad and participate in worldwide business. However, the foreign tax credit law does not satisfy requirements of national policy and is not congruous with the two inherent objectives discussed above. For reforms to proceed from Chinese economic and social reality, they must contain these two inherent objectives.

to avoid resident jurisdiction, see KLEINBARD, «Stateless Income», *cit.*, p. 728 (proving mechanics including business earnings stripping, legal system arbitrage, and transfer pricing).

[20] See JIANWEN LIU, «Institutional Innovations in the New Enterprise Income Tax Law», *International Taxation in China*, 08, 2007, p. 40; LONGYING SUN, «A Review on Current Enterprise Foreign Tax Credit System», *International Taxation in China*, 07, 2011, p. 21 [hereinafter SUN, «A Review on Current Enterprise Foreign Tax Credit System»]; See also HAO WU, «Analyses on the Taxation on Foreign Income of the New Enterprises Income Tax Law», *China State Finance*, 09, 2012, p. 30.

A. *Current Foreign Tax Credit Rules in China*

Presently, foreign tax credit in China is prescribed by a four-layer tax law regime. The top one is Articles 23 and 24 of the *Enterprise Income Tax Law of the People's Republic of China* (hereinafter, the *EIT*). It provides that China adopts the foreign tax credit as the fundamental method to relieve international double taxation; credits apply to income from foreign direct investment and equity investment and are subject to an overall limitation[21]. The second layer is covered by the *Regulation on the Implementation of the Enterprise Income Tax Law of the People's Republic of China* (hereinafter, the *Implementation Regulation*)[22]. Articles 76 to 81 of the *Implementation Regulation*, which correspond to the *EIT*'s Articles 23 and 24, define terms in the *EIT*, stipulate the minimum equity-holding requirement for indirect credits and provide basic formulas for calculating the limitation[23]. Notably, it is the *Implementation Regulation* that clarifies the foreign tax credit in China to adopt the per-country limitation[24]. The lower layer, the *Notice of the Ministry of Finance and the State Administration of Taxation on Issues Concerning the Foreign Income Tax Credit of Enterprises* (hereinafter, the *Notice*) and the *Operating Guidelines on Tax Credits for Offshore Income of Enterprises*

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[21] The *Enterprise Income Tax law* was issued by the National People's Congress (NPC). Available at *http://www.lawinfochina.com/display.aspx?lib=law&id=5910&CGid.*

[22] The *Regulation on the Implementation of the Enterprise Income Tax Law of People's Republic of China* was issued by the State Council, and the level of authority is administrative regulations. (Order of the State Council of the People's Republic of China No. 512).

[23] See *Implementation Regulation* is available at *http://en.pkulaw.cn.ezproxy.law.wustl.edu/display.aspx?cgid=100121&lib=law.* For example, the term "amount of income taxes paid overseas" as used in Article 23 of the EIT Law refers to "the amount of taxes in the nature of income tax that an enterprise is due for the incomes sourced outside of China pursuant to the foreign tax laws and regulations and has in effect paid". And the term "amount of deduction and exemption" refers to the amount of taxes as calculated under the EIT Law and the present Regulation for the enterprise's income sourced outside of China". "Direct control" as used in Article 24 of the EIT Law refers to an equity of 20% or more a resident enterprise directly holds in a foreign enterprise. Amount of deduction and exemption = total amount of taxes calculated under the EIT Law and the present Regulation for the incomes sourced both inside and outside of China × taxable amount for the income sourced from a certain country (region) ÷ total amount of taxable income sourced both inside and outside China.

[24] See *Id.* Article 78. "Unless it is otherwise differently provided for by the competent department of treasury or taxation of the State Council, the amount of deduction and exemption shall calculate regard to the different countries (regions)".

(hereinafter, the *Operating Guidelines*), are recognized as specific guidance regarding the enforcement of foreign tax credit rules for taxpayers and tax authorities[25]. The *Notice* clarifies certain basic aspects of the foreign tax credit, including eligible taxpayers, creditable taxes, calculation methods, and treatments of excess credits. It also provides indirect tax credit to offset taxes on dividend income from foreign subsidiaries[26]. The *Notice* draws outlines of the foreign tax credit pragmatically, while leaving more issues ambiguous, such as how to coordinate different source rules between resident and foreign countries, how to allocate expenses that incurred both domestically and abroad, and how to treat differences in accounting principles. The *Operating Guidelines* is an instruction guide of the *Notice*. It explains every article of the *Notice*, and even illustrates the calculation process in detail. However, the *Operating Guidelines* does not provide detailed guidance to any of the problem above[27].

B. *Restrictive Rules Are Inconsistent with Normative Objectives of the Foreign Tax Credit*

As elaborated in the first part, the ideal foreign tax credit rules should embody two normative goals, that is, relieving international double taxation and protecting the resident country's tax base. China's foreign tax credit fails to stress the dual goals to some extent; the restrictive rules imply a conservative attitude toward relieving the burden of Chinese enterprises while the rough stipulation of the regime leaves some loopholes in preserving China's tax base.

Restrictive foreign tax credit rules demonstrate several aspects, the foremost regarding the limitation rule. Apart from the overall limitation that prevents resident tax bases from erosion, limitations are also imposed for the purpose of restricting taxpayers to cross credit or to "blend" different transactions

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[25] These two regulations are promulgated by Ministry of Finance and State Administration of Taxation. The level of authority is Departmental Regulatory Documents.

[26] See Articles 2, 5, 6, and 10 of *Notice of the Ministry of Finance and the State Administration of Taxation on Issues Concerning the Foreign Income Tax Credit of Enterprises.* Available at *http://en.pkulaw.cn.ezproxy.law.wustl.edu/display.aspx?cgid=125467&lib=law.*

[27] See *Operating Guidelines* is available at *http://en.pkulaw.cn.ezproxy.law.wustl.edu/display.aspx?cgid=135406&lib=law.*

that make an artificial maximum use of credits. As mentioned previously, China's foreign tax credit adopts a "per-country" pattern as the limitation on income categories[28]. Theoretically, the more accurate income categories that are set, the less cross credit that will happen; therefore, the most precise limitation needs to review every transaction of every country. Nevertheless, no country adopts such an extreme method due to the huge compliance costs and the impractical reality of implementing it. As a consequence, the origin and character of the income become two benchmarks that set the limitation. Currently, China's foreign tax credit uses the per-country approach; it increases taxpayers' compliance burdens while failing to address how multinationals use manipulation in the digital economic age.

The formula for calculating the per country limitation is as follows: the total amount of taxes calculated under the Chinese EIT Law for the incomes sourced both inside and outside of China × the taxable amount for the income sourced from a certain country (region) ÷ the total amount of taxable income sourced both inside and outside China. Notably, it is a trend for Chinese enterprises to invest in more than one country, requiring taxpayers to calculate each country's limitation and get credits one-by-one, and thus greatly increasing their compliance burdens. From a business perspective, arranging economic activities worldwide is very common, and it is an ordinary strategy to conduct global business for multinational enterprises. Per-country limitation artificially separates the international market and increases risks of investing abroad. It is highly possible that taxpayers must pay residual taxes for income generated in lower rate countries while holding extra credits for taxes paid to higher rate countries under the per-country limitation. Especially when combined with rules prescribing uncredited taxes a five-year period to carry forward (while not allowed to carry back)[29], some international double taxation may never be relieved. However, allowing income of different characters to blend may erode China's tax bases. Incomes of different characters are naturally distinctive in every aspect: they are generated by different activities, apply different rates, and are assessed differently in the legislation process. Limitation rules of the

[28] See *supra* note 24.

[29] See Article 79 of the *Implementation Regulations*, available at *supra* note 23.

foreign tax credit should also be separately prescribed based on characters. For instance, with the approach of a digital economy, passive income has been amplified explosively[30]. Considering the easy-to-transfer nature of passive income, under the per-country limitation, multinationals have incentives to concentrate global passive income in a particular country that incurs losses on active business to reduce taxable income, or in a country that has a lower tax rate on passive income but a higher tax rate on active income than China to exploit extra credits while paying less actual taxes. Those schemes are easy to operate but intensely harmful to China's tax jurisdiction[31]. Briefly, the per-country limitation results in heavy compliance burdens, but it barely achieves in protecting the tax bases.

Another restrictive rule targets loss deductions. According to Article 17 of the *EIT*, losses of a foreign country's business are not allowed to offset the profits of other foreign or domestic business[32]. However, the *Operating Guidelines* prescribe that domestic losses can offset foreign profits[33]. Admittedly, this rule reduces side effects on China's tax bases by segregating foreign losses. Nevertheless, this "one-way" loss deduction discriminates against enterprises incurring losses abroad from getting credits. This rule overstates enterprises' worldwide income, because if a Chinese enterprise profits and holds extra credits in a foreign country while losing money in another, it has to accept unrelieved double taxation regardless if losses exist. In addition, the one-way deduction rule increases risks of international investment and even affects the overall business judgement. This rule breaks from the normal practice of risk-sharing in

[30] See OECD, *Addressing Base Erosion and Profit Shifting*, 2013, available at *http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en#page15*.

[31] In the real world, the largest multinational companies heavily rely on intangible properties to manipulate passive income and to sharply decrease their tax liabilities to the resident country. See CHARLES DUHIGG & DAVID KOCIENIEWSKI, «How Apple Sidesteps Billions in Taxes», *N.Y. Times*, Apr. 28, 2012; JESSE DRUCKER, «Google Revenues Sheltered in No-Tax Bermuda Soar to $10 Billion», *Bloomberg*, Dec. 10, 2012; RICHARD WATERS, «Microsoft's Foreign Tax Planning Under Scrutiny», *Financial Times*, June 7, 2011.

[32] See Article 17 of the *EIT* of China, available at *supra* note 21.

[33] See Article 27 of the *Operating Guidelines*, available at *supra* note 27.

multinational businesses and potentially restrains some oversea investments with relative high risks of incurring losses[34].

Thirdly, the reduced tax rate prescribed by the *EIT* does not apply to the case of foreign tax credits. Based on Article 28 of the *EIT*, high-and-new-technology enterprises are granted a preferential tax rate of 15%[35]. However, when enterprises derive income from a foreign source and calculate the residential tax on worldwide income, a general 25% tax rate applies uniformly, even to the qualified high and new technology enterprises[36].

Finally, requirements for obtaining indirect foreign tax credit are restrictive. The "direct" credit is granted for profit income from foreign direct investment, while the indirect credit is granted for dividend income repatriated from foreign subsidiaries to parent corporations. China adopted the indirect credit rule in 2008. It stipulated that the eligible enterprise must hold no less than 20% equity of a foreign subsidiary, and after multiplying the percentage of each tier of a company's equity shares, the result shall be no less than 20%. Indirect credits cover the third layer subsidiary at most[37]. Compared to other countries, these rules are exceedingly strict in the minimum requirement of stock ownership and the maximum number of creditable layers[38]. In practice, a considerable amount of dividend income is under double taxation since equities of multinational enterprises are rarely concentrated in such a high percentage. Multilayer structure is a well-recognized method of management for modern enterprises. However, China's indirect credit rules will not grant credits to income from subsidiaries lower than the third layer. Moreover, according to the *Operation Guidelines*, if the second layer foreign subsidiary invests back in China, namely,

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[34] See WEI CUI, «Suggestions on the Tax Issues Related to Outbound Investment of Chinese Enterprises», *Taxation Research*, 11, 2009, p. 58.

[35] See *supra* note 21.

[36] See Article 26 of the *Operating Guidelines*, available at *supra* note 27.

[37] See Article 80 of the *Implementation Regulations*, available at *supra* note 23.

[38] For example, the equity ownership of the US indirect credits rules requires at least 10% voting stock of the lower one subsidiary, and after multiplying each tier's shares, the final result must not less than 5%. As to the creditable subsidiaries, some countries' indirect credits rules don't limit how many layers, as long as equity of each tier's subsidiary meet the minimum standard. Such countries include Australia, Ireland, South Africa, and Great Britain.

the third subsidiary being the Chinese enterprise, then dividends from such a scenario cannot get credits[39].

Accordingly, China's foreign tax credit is prescribed in a conservative and restrictive pattern. It stresses preservation of Chinese tax bases while ignoring the function of relieving international double taxation that deviated from the normative requirements of the system. Having an imbalance of the two objectives is not only defective from a theoretical perspective, but it also impedes the practice in a more profound sense.

C. *Specific Rules Remain to Be Improved in Detail*

China's foreign tax credit was enacted in 2008, but its legislature, administrative authority and taxpayers are inexperienced as this regime is relatively unfamiliar. Current rules establish the basic framework of the foreign tax credit, but they prescribe this framework generally and incompletely, lacking concrete implementation details and are inadequate in solving real problems. However, specific provisions of the foreign tax credit are extremely significant because they determine whether a taxpayer can get credits and the number of credits that may be obtained.

The foremost source rule has yet to be clarified. Source rule is the law that assigns income to a particular jurisdiction. It is exceedingly important since it delineates the boundary of resident and source jurisdictions. China's source rule classifies income as coming from the sale of goods, providing of services, transfer of property, equity of investment, and interests, rents, and royalties and then respectively designates the "sources" of these categories[40]. Nevertheless, the source rule is stipulated on a general, broad and conceptual level, framing an overall structure while leaving a lot of practical problems that turn obstacles into real credit processes[41]. The following problem is that the regulation only prescribes different income types, leaving out the issue of determining the category a particular income belongs. This has been controversial in practice be-

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[39] See Article 18(1) of the *Operating Guidelines*, available at *supra* note 27.

[40] See Article 7 of *Implementation Regulations*, available at *supra* note 23.

[41] See SUN, «A Review on Current Enterprise Foreign Tax Credit System», *cit*.

cause taxpayers always seek to characterize their income to the category most favorable to them[42].

Besides the source rule, expense allocation rules remain to be specified as well. The recognition and allocation of expenses determine taxable income and the final tax liability. Clearly defined expense allocation rules are instrumental for taxpayers to get credits successfully and for the resident country to defend its tax base. Unfortunately, China's current expense allocation rules do not meet the expectations. It stipulates that "the relevant reasonable expenses on taxable income sourced outside China shall be deducted after being apportioned at a reasonable proportion"[43], while "relevant" and "reasonable" are not defined. Moreover, there are no special rules to stipulate interest expenses or research and development (R&D) expenses. Proper allocation of interest expenses is a troublesome issue because money is fungible. Taxpayers can finance investment in any way they desire to achieve substantial reductions in income tax liabilities. For research and development expenses, the allocation is not an easy task either. The results of research and development may contribute to production both domestic and abroad, and it is harder to estimate the amount of expenses that can be allocated to each category before the research benefits the business. Taxpayers have the incentive to allocate amounts as small as possible as foreign source to maximize allowable foreign tax credits.

The "One Belt, One Road" initiative and the "go global" strategy will certainly encourage Chinese enterprises to conduct international business and to bring more open communication between China and the world. Meanwhile, increasing cross border transactions raises requirements for protecting China's

[42] Because tax treaties between countries provide various treatments (or benefits) towards different categories of income, taxpayers with income from international transactions seek to apply the most favorable clause to save taxes. For example, according to the "Convention between the United States and the Germany for the Avoidance of Double Taxation with Respect to Taxes on Income", royalties derived by a Germany person from the US is exempted from the withholding tax, while the compensation for labor or personal services is exempted from the US source tax only under certain circumstances. Available at *https://www.irs.gov/pub/irs-trty/germany.pdf*. If a taxpayer cannot fit himself/herself into the exemption situations of service income, it is a commonly adopted strategy for him/her to argue the "service fee" as "royalties". See Boulez v. Commissioner 83 T.C. 584.

[43] See at Article 3(4) of the *Notice*, available at *supra* note 26.

tax base. Undoubtedly, current foreign tax credit rules are inadequate in dealing with complicated business situations. The necessity for refining and perfecting foreign tax credit is more compelling in this period.

III. Reforming China's Foreign Tax Credit with a Liberal Approach

A. *China's Economy is in a Historical Transitional Period*

By any standard, the rapid rise of the Chinese economy is one of the greatest successes in the last forty years. The average 10% annual growth of gross domestic product (GDP) has astonished the world. China is now the largest manufacturer, the largest exporter, and the second largest economy in the world[44]. One significant distinction of Chinese economic development is that China attracted tremendous foreign direct investment in its development journey; foreign capital and technology provide essential resources to boost productivity and economic growth. During the last twenty years of the 20th century, China was a pure capital importer and its outbound investment was sharply restricted. After 2000, the "go global" strategy was presented as national policy, encouraging Chinese enterprises to go abroad and to participate in the international market[45]. Business in the international market provides opportunities for Chinese enterprises to develop advanced technology, management skills, sophisticated labor, and to help them build internationally recognized brands, find broader markets and make more profits[46].

[44] See World Bank, China 2030: Building a Modern, Harmonious, and Creative High-Income Society XV (2013) available at: *http://www.worldbank.org/en/news/feature/2012/02/27/china-2030-executive-summary.*

[45] See 2015 Statistical Bulletin of China's Outward Foreign Direct Investment, at p. 6. Available at: *http://hzs.mofcom.gov.cn/article/date/201612/20161202103624.shtml.*

[46] For example, with the improvement of enterprise strengths and encouragement of the national policy, the Lenovo Group Limited, a Chinese computer company, purchased IBM Corporation's personal computer division for $1.75 billion in 2005. See Wayne M. Morrison, «China-US trade issues», *Current Politics and Economics of Northern and Western Asia*, 20, no. 3, 2011, p. 409.

China's outbound investment started late and grew rapidly after 2010[47]. By the end of 2014, 185,000 Chinese investors had established 29,700 foreign direct investment enterprises in 186 countries around the world[48]. The total assets of overseas enterprises had been $3.1 trillion, and the accumulated outward net stock had reached $882.64 billion[49]. 2014 was a significant year for China's foreign investment, as it had witnessed China's outward FDI achieve a historical high of $123.12 billion, with a year-on-year growth rate of 14.2%, thereby, making China the third largest outward investor in the world for three consecutive years. Meanwhile, China's actual use of foreign investment was $128.5 billion in 2014, ranking number one in the world for the first time. This was also the first time that China's outward foreign direct investment achieved a balance with the foreign direct investment, demonstrating that China was in a historical transitional period from a net capital importer to a huge capital exporter.

In 2013, Chinese President Xi Jinping launched the New Silk Road Economic Belt and the 21st century Maritime Silk Road, also known as the "One Belt, One Road" initiative, to deepen reform and to hasten the opening of China to the rest of the world[50]. This initiative was positioned as China's top national development strategy by the Chinese government in early 2015. This framework focuses on connectivity and cooperation among countries primarily across Asia, Europe and Africa, covering more than one hundred countries with a total

[47] The National Bureau of Statistics of China began to release the annual data from 2003. According to the bulletins, China's outward FDI had continuously increased for 12 years, with the flows in the year of 2014 45.6 times to flows in 2002, and an average annual growth rate of 37.5% between 2002 and 2014.

[48] See 2014 Statistical Bulletin of China's Outward Foreign Direct Investment. Available at: *http://hzs.mofcom.gov.cn/article/date/201510/20151001130306.shtml*.

[49] Among the stock, $356.9 billion had been equity investment, $383.93 billion had been reinvestment of earnings and $141.81 had been debt instrument investment, accounting for 40.4%, 43.5% and 16.1% of the total respectively. However, its stock was still far less than that of developed countries by the end of 2014, being only equivalent to 14% of the United States', 55.7% of the United Kingdom's and Germany's, 69% of France's, and 74% of Japan's respectively during the same period. See Id. See also the UN data, China's annual FDI outflows rose from $12.3 billion in 2005 to $116 billion in 2014, an 843% increase.

[50] See the Speech of President Xi Jinping in the Congress of Indonesia on 3 October, 2013. Available at: *http://www.xinhuanet.com/world/xjpynghyj/*.

population of 4.4 billion and an aggregate economic size of $21 trillion[51]. The initiative calls for the integration of these regions into a cohesive economic area through building infrastructure, increasing cultural exchanges, and broadening trade. For example, the initiative proposed the construction of a network of railways, highways and other infrastructure, including gas pipelines, power grids, internet networks and aviation routes in the Eurasian area. In addition, the Asian Infrastructure Investment Bank led by the Chinese government was established in December 2015 to provide financial support for infrastructure projects in Asian regions. In addition, as an extension of the "go global" strategy, China's State Council unveiled its 'Made in China 2025' policy in May 2015, which gave a high strategic priority for Chinese manufacturing firms to build their global brands and to move up the global value chain in manufacturing[52].

Under this circumstance, Chinese enterprises are in the historical crucial point of their time as well. With political and financial support, it could be expected that a continuous increase of China's outbound investment will happen in the next decades. On one hand, Chinese enterprises need to strengthen and become more competitive to increase profits; on the other hand, they represent Chinese economic developments and shoulder the responsibility to enhance national policy in the new era. Many Chinese enterprises take on infrastructure construction programs in foreign countries; they need to cope with difficulties from huge investment, long return cycles and relatively high risk. Taxation is closely connected with business activities, and it influences strategies and judgement of enterprises. According to prior analysis, current foreign tax credit in China is prescribed restrictively, and detailed rules remain to be clarified. To comply with the present economic reality and to promote the implementation

[51] See the Prospect and Action of "One Belt and One Road" initiative, jointly issued by National Development and Reform Commission, Ministry of Commerce and Ministry of Foreign Affairs of People's Republic of China. Available at *http://www.pkulaw.cn.ezproxy.law.wustl.edu/fulltext_form.aspx?Db=chl&Gid=269024&keyword=%E6%8E%A8%E5%8A%A8%E5%85%B1%E5%BB%BA%E4%B8%9D%E7%BB%B8%E4%B9%8B%E8%B7%AF%E7%BB%8F%E6%B5%8E%E5%B8%A6&EncodingName=&Search_Mode=like*.

[52] See Notice of the State Council on Issuing the "Made in China (2025)", available at: *http://en.pkulaw.cn.ezproxy.law.wustl.edu/display.aspx?cgid=248573&lib=law*.

of the "One Belt, One Road" initiative, China's foreign tax credit needs to reform in a liberal approach.

B. *Reforming Suggestions: Combining the Liberal Foreign Tax Credit with Jurisdiction Protection Mechanism*

China's current economic status requires a more congruent international taxation policy and regime towards income of resident enterprises. Moreover, with the approach of the digital age, the entire international taxation order is experiencing significant reform[53]. Global organizations, countries at different development stages, and multinational enterprises are all making efforts to adjust and adapt[54]. Under these circumstances, reforming China's foreign tax credit is an inevitable step from both domestic and international perspectives[55].

The foreign tax credit regime has yet to be improved in principle and in the details. A liberal approach should be applied and specific guidance on key issues such as source rules and expense allocation rules should be clarified. Considering the current status of China's foreign tax credit and the normative objectives of this regime, this article presents the following reform suggestions:

The first approach is to enhance the active/passive income distinction in the foreign tax credit. The distinction between active and passive income determines the fundamental structure of international taxation[56]. The two types of income are naturally distinct, and the active/passive distinctions thoroughly

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[53] See BRAUNER, «What the BEPS?», *cit.*; See OECD Public Discussion Draft, BEPS Action I, Addressing the Tax Challenges of Digital Economies, 2015 Final Report, 5 Oct, 2015. Available at *http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en#.WJdOJvArJPY#page2*.

[54] See Compilation of Comments Received in Response to Request for Input on Tax Challenges of the Digital Economy, OECD, January, 2014, p.18. Available at *https://www.oecd.org/ctp/comments-received-tax-challenges-digital-economy.pdf.*

[55] See YIXIN LIAO, «How to Determine the Legal Character of Turn-over Tax in E-commerce», *Law Science*, 03, 2005; ZEPING ZHANG, «Economic Allegiance Principle in the Allocation of International Tax Jurisdiction», *Academic Monthly*, no. 2, 2015.

[56] See LEAGUE OF NATIONS, *Report on Double Taxation*, Doe. E.F.S. 73 F. 19, 1923; REUVEN S. AVI-YONAH, «The Structure of International Taxation: A Proposal for Simplification», *Tex. L. Rev.*, 74, 1996, p. 1301.

reflect the entire international taxation regime[57]. Introducing the character-based methodology to classify income confronts this basic structure. Active income is derived from conducting "regular, continuous and considerable" business activities, and passive income include "interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income"[58]. Adopting this classification method will profoundly affect the limitation of the foreign tax credit. As previously mentioned, the per-country limitation results in heavy compliance burdens for taxpayers but barely satisfies the anti-avoidance objective. Classifying income and setting limitation categories on characters relieve taxpayers from the administrative burden of counting taxable income and countries' credits one-by-one. For the cross-crediting concern, after reforming to character-based limitation, blending will happen within one category as well, whereas the same character income applies the same tax rate, and low rate of passive income will not affect the high rate active income. Once forbidding passive income to cross credit with business income, tax planning tactics of maneuvering intangible property to decrease the residual tax liability to the home country will not be effective anymore. In addition, modest cross crediting within the active income category can promote Chinese enterprises to take a global perspective in arranging business operations and increase international competitiveness. Given the generous outcome of the current U.S. foreign tax credit resulting from the passive and active categories[59], the reform in China may consider classifying income more accurately[60].

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[57] The active/passive income distinction underlies every regard of international taxation: tax jurisdiction, source rules, controlled foreign corporation rules, taxation on foreign persons, tax treaties, and foreign tax credit.

[58] These definitions come from the *US Internal Revenue Code,* See 26 U.S. Code § 871 – Tax on nonresident alien individuals, 26 U.S. Code § 881 – Tax on income of foreign corporations not connected with United States business, available at *https://www.law.cornell.edu/uscode/text/26/881*. For explanation, see GUSTAFSON, PERONI & PUGH, *Taxation of International Transactions..., cit.*

[59] See FLEMING, PERONI & SHAY, "Worse Than Exemption", *cit.*; J. CLIFTON FLEMING, JR. & ROBERT J. PERONI, «Eviscerating the Foreign Tax Credit Limitations and Cutting the Repatriation Tax--What's ETI Repeal Got to Do with It?», *Tax Notes*, 104, 2004, pp. 1393, 1406 (proving that unlimited cross-crediting is essentially allowed).

[60] Passive income derives from various situations. Control extent is considering categorizing passive income as further standard. Take the US for example, between 1986 and 2004, a nine-basket

The second essential aspect is to refine and specify loss deduction and expense allocation rules[61]. This article suggests reforming the "one-way" loss deduction rule, allowing loss incurred in a foreign country to offset foreign profits. Apparently, this reform should establish the foundation of character-based limitation. Since current per-country limitation inherently forbids offsetting between countries, to prevent foreign loss from decreasing domestic taxable income, the foreign loss cannot offset domestic profits. When cross crediting of one category is allowed as long as profits are foreign, advantages of international intensive operation can be expected, and this benefit means a lot, especially to Chinese enterprises building infrastructure with high risk and long return cycles in foreign countries. Confining the cross crediting within foreign income and not allowing the overall foreign losses to offset domestic income can help defend the domestic tax bases[62].

As for the expense allocation rules, interest expenses and R&D expenses need special consideration. For the former one, assets are recognized as a better benchmark than gross income because it is much easier to manipulate gross income than assets within a multinational enterprise. Interest expenses and gross income can be concentrated in a particular jurisdiction by inter-group transactions, while assets always connect back to active business operations. The assets-based interest expense allocation methodology complies with the

limitation system was used. These nine categories are passive basket, high withholding-tax-interest basket, financial service basket, shipping basket, non-controlled section 902 corporation basket, domestic international sales corporation dividend basket, foreign sales corporation foreign trade income basket, dividends from a foreign sales corporation attributable to earnings and profits or interest derived from transactions that generate foreign trade income basket, and general basket which includes income not covered by any other baskets. See Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1201, § 904(d), 100 Stat. 2085, 2520-28 (codified as amended at I.R.C. § 904 (1994)), available at *https://1.next.westlaw.com/Document/I4B69EEE9A1E642ECA21E401F8D0A45CF/View/FullText.html?originationContext=document&contextData=(sc.DocLink)&cacheScope=undefined&transitionType=DocumentItem&searchWithinQuery=2085&chunkSize=S&docSource=befe0f7d1c7b42cbbbbcf8d8827db551&needToInjectTerms=False&searchWithinHandle=i0ad6180e0000015dc9d8dcc122c6db98*.

[61] Source rules in China remain to be improved as well; it is beyond the scope of this article. Source rule issue is one of the most significant facets of international taxation, due to the topic and length limitation, this part does not discuss reform suggestions for source rules.

[62] For example, see J. CLIFTON FLEMING, JR. ROBERT J. PERONI & STEPHEN E. SHAY, «Designing a US Exemption System for Foreign Income When the Treasury is Empty», *Fla. Tax Rev.*, 13, 2012, pp. 397, 454.

economic valuation creation process. With respect to R&D expenses, it could adopt a two-step allocation process. First, R&D expenses would be allocated to related items of income, and second, those expenses would be further allocated between domestic and foreign jurisdictions If the research is undertaken to meet legal requirements by a jurisdiction concerning the manufacturing or marketing of specific products, and the outcome does not generate gross income outside the geographic boundary, the deduction can only be allocated to the gross income within that geographic place. Evidently, government requirement is a factor superior to the location of research conduction. Besides government requirement, the location where the sales happen and where the gross income derives may also be considered factors in allocating R&D expense.

Finally, requirements should be lowered for indirect foreign tax credit and the preferential rate for high-technology enterprises should be applied to the worldwide income of qualified enterprises. In 2016, Chinese enterprises performed notable job on the international business acquisition market, doubling the foreign acquisitions of $106 billion made in 2015[63]. Indeed, equity investment has been an important choice for Chinese enterprises to invest abroad, and Chinese enterprises have increasingly become shareholders of foreign corporations. As mentioned before, it is very common that equities are dispersed in the multi-layer business structure. Therefore, requiring the result of multiplying the equity percentage of each tier to be no less than 20% actually sets substantial barriers for dividend income to obtain credits. In spite of the huge developments Chinese enterprises have achieved, it cannot be ignored that Chinese enterprises are in a rudimentary development stage; they largely depend on the manufacturing industry instead of core innovations to participate in international competition, and the relatively low-end products and brands fail to help Chinese enterprises to earn profits in the long run. Excluding the worldwide income of high-technology enterprises, the favorable tax rates imply "discrimination" on foreign source income to some extent and discourage high-tech-

[63] In one example of this massive increase, China National Chemical Corp. spent $43 billion purchasing Swiss pesticide maker Syngenta AG, which would be the largest outbound deal ever by a Chinese company. See International Trade Reporter (BNA), 33 ITR, Issue No. 47, available at *https://www.bloomberglaw.com/search/results/5a15635843f2ac40bc5d06bbe88790a1/document/X5BRC7O0000000*.

nology enterprises to go global. The update and restructuring of China's economy largely depend on Chinese high-technology enterprises to innovate, and these enterprises are expected to represent China in the new era. The "One Belt, One Road" initiative has called for increasing the competitiveness and strength of Chinese enterprises, encouraging foreign equity investment and promoting development of high-technology enterprises. To comply with the national policy, liberal approaches to reform Chinese foreign tax credit should be adopted.

As previously analyzed, the protection of China's tax jurisdiction as well as the relief of international double taxation are the two normative objectives of foreign tax credit. In fact, multinational enterprises have undertaken aggressive tax planning strategies to circumvent resident jurisdiction, and this practice has posed serious problems around the world. It should be noted that a liberal approach by no means grants Chinese enterprises opportunities to take advantage of the system. For China's foreign tax credit reform, it is essential to take a holistic perspective to put it in the system of outbound taxation regime. It is also important to enhance its function of preserving the Chinese jurisdiction among sovereignties on the international stage.

The international taxation system of one country is a series of laws and regulations that prescribe taxation issues regarding cross-border transactions. The foreign tax credit, as an essential part of taxation on residents' foreign source income, is closely connected to other related rules within the outbound taxation regime. As a result, legislators designing the foreign tax credit should give careful consideration to the comprehensive effects of combining the rules. The foreign tax credit is supposed to relieve Chinese enterprises of the burdens of international taxation, while it could be reconcilable for a liberal foreign tax credit system to coordinate with other international taxation aspects such as source rules, entity choice, controlled foreign corporation and tax treaties to defend the Chinese tax jurisdiction. For example, liberal foreign tax credit rules may cooperate with restrictive entity transfer rules. Or, if a foreign branch incurred loss before, it will be forbidden to change the form of the branch to a corporation after making profits to stop the exploitation of both the loss deduction rule and deferral privilege. From a more holistic perspective, it should be noted that in addition to substantial rules, procedures serve a considerable role

in protecting the domestic tax base. Examples of these procedures include raising the documental requirements, increasing the standards and frequency of the inter-group information reports, or putting more stress on information exchange actions towards offshore accounts. Procedural stipulations may solve the information discrepancy problem and defeat foreign tax credit practices that ultimately depart from economic substance[64]. Combining liberal substance with restrictive procedure works as a "filter" to exclude enterprises that practice tax avoidance. Additionally, in 2015, State Administration of Taxation in China promulgated the Measures for the Administration of General Anti-Tax Avoidance. This regulation is a good example of the possible integration of a liberal foreign tax credit system and anti-avoidance procedures to protect China's tax bases. The measures grant tax administrative bodies general anti-avoidance authority to combat tax evading practices. Undoubtedly, if Chinese enterprises exploit the reformed liberal foreign tax credit system and obtain tax benefits not for reasonable commercial purposes in the future, the general anti-tax avoidance rules will defeat these manipulations and protect China's tax base[65].

In conclusion, the objective economic situation in China and the current national policy require a liberal reform of foreign tax credit; on the other hand, protecting Chinese tax base is the other pillar of the international taxation regime. To ensure China's robust development, the future foreign tax credit in China should include adopting a holistic approach to coordinate the interests of enterprises and the nation and combining the substantial and procedural measures.

[64] See ITAI GRINBERG, «The Battle over Taxing Offshore Accounts», *UCLA L. Rev.*, 60, 2012, p. 304.

[65] "Tax avoidance arrangements" means arrangements made for the sole purpose or primary purpose of obtaining tax benefits, or tax benefits are obtained through the methods which comply with the provisions of the tax law but are inconsistent with the economic substance thereof. See Articles 2 and 3 of *Measures for the Administration of General Anti-Tax Avoidance*, available at: *http://en.pkulaw.cn.ezproxy.law.wustl.edu/display.aspx?cgid=239563&lib=law.*

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