INSIDE THE EU CODE OF CONDUCT GROUP: 20 YEARS OF TACKLING HARMFUL TAX COMPETITION

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SUMMARY, CONCLUSIONS, AND OUTLOOK

INSIDE THE EU CODE OF CONDUCT GROUP: 20 YEARS OF TACKLING HARMFUL TAX COMPETITION

1. Introduction

The twentieth anniversary of the Code of Conduct Group (Business Taxation) on 9 March 2018 is a good occasion to ask the research question to what extent the Code of Conduct for Business Taxation and its governing body, the Code of Conduct Group, have been successful in realizing the goal of the Code; i.e., curbing harmful tax competition and with that, reducing tax avoidance opportunities within the EU. Answering this question has not been easy, given the Group's diplomatic character, implying confidentially and closed meetings. With the help of the EU Transparency Regulation and much persistence, more than 2,500 unpublished documents on the work of the Group were obtained from the Council and the Commission. They proved to be of great scientific value and provide a rare glimpse into the decision-making process and results of the Group, and with that, into its effectiveness and the positions of individual Member States on preferential tax regimes and tax avoidance practices.

This study discussed and evaluated the work of the Group. It assessed the substance and effectiveness of the Group's decisions in respect of national preferential tax regimes (pseudo-case law (Section 7.1); one-country issues) and in respect of coordinated tax policies on general competition sensitive tax issues (pseudo-legislation (Section 7.2); two-or-more-country issues), as well as the interaction between the Code (soft law) and hard law, notably the EU State aid rules and the market distortion rules (Section 8). First, however, this study analyzed the historical background and purpose of the Code (Section 2), its legal status (Section 3), the governance and working methods of the Code Group (Section 4), and the geographical and substantive scope of the Code (Sections 5 and 6). Indeed, both the nature and scope of the Code and the governance and working practices of the Group have a major impact on the Group's effectiveness in addressing harmful tax policy competition and with that, in reducing international tax avoidance. This final Chapter concludes with an outlook on the Group's future.

2 The historical background and purpose of the Code *(Chapter 2)*

This study has shown that the drafting of the Code was a tedious and delicate process, but led to a landmark adoption of a diplomatic gentleman's agreement, i.e., the Code of Conduct for Business Taxation, to avoid 'fiscal degradation' (loss of tax base and revenue) caused by excessive tax policy competition between Member States. Following the Ruding Report (1992), which already warned against the harmful effects of increasing tax competition between Member States, EU-Commissioner Monti in 1996 proposed a Code of Conduct as the central pillar of a comprehensive 'tax package', consisting of both legislative and non-legislative

measures in different tax fields, representing a balance of interests between Member States, with both sticks and carrots for everyone.

The non-legally binding Code, based on political agreement, diplomacy and confidentiality, appeared to be quite useful after it had become clear that some degree of harmonisation of the base of corporate taxation, and a minimum tax rate, as proposed by the Ruding Report, was unrealistic given the unanimity requirement in taxation matters and the general perception among most Member States that harmonisation would seriously undermine their national sovereignty. The impressive work by the Commission's Taxation Policy Group, headed by Commissioner Monti, paved the way for the ground-breaking political agreement, on 1 December 1997, on a tax package consisting of (i) the Code of Conduct in the form of a Council Resolution (see Section 3) and (ii) a call on the Commission to submit proposals for EU directives on savings income and cross-border intragroup interest and royalty payments. The political link between the Code and the two other parts of the tax package has been of vital importance in reaching political agreement on the elimination of many harmful tax regimes during the Group's first years of work.

Furthermore, the Code's *travaux préparatoires* uncover the policy considerations underlying the adoption and the non-adoption and the framing of (proposed) provisions of the Code, including the following insights:

- Member States swiftly agreed on a non-binding political nature of the Code, rather than pursuing the adoption of a legally binding instrument, which could have been more effective if adopted, given that Member States sometimes failed to comply with their political commitments (see Section 7), but which ran a more serious risk of not being adopted at all;
- Until the very last minute, Member States remained deeply divided on the question of whether or not to bring special tax arrangements for employees within the scope of the Code, eventually leading to the omission of such regimes;
- Inclusion of indirect taxation regimes was not considered feasible, nor was a separate measure for such regimes, given the complexity of the problems in this area and the resistance of several Member States; and
- Member States did not consider it useful to include sanctions for non-compliance in the Code; peer pressure and moral/political sanctions, especially in the form of discussions in the Council, possibly leading to Council conclusions, were considered sufficient. In hindsight, the correctness of this assumption may be doubted in the light of the lack of compliance by certain Member States, especially in the field of pseudo-legislation (see Section 7).

3. The legal status of the Code (*Chapter 3*)

The Code is 'soft law'; it was adopted in the form of two atypical acts: (i) a mixed Resolution; and (ii) (annexed to) Council Conclusions. It is a 'mixed' resolution because it was adopted jointly by the Council and the Representatives of the Governments of the Member States, meeting within the Council. The consent of the latter was a prerequisite since the material and geographical scope of the Code affects the sovereign competences of Member States.

This study characterized the Code as an informal para- and pre-law steering instrument. Its policy steering function is evident from the (i) Preamble to the Resolution, which underlines the political need for joint EU-action to tackle harmful tax competition to achieve important internal market objectives and (ii) the Resolution itself, which specifies a set of principles and

criteria to be implemented and respected by all Member States, even though they are not legally binding. It is 'informal' because a (mixed) resolution is not provided for in the EU Treaties. The Code, to the extent it is implemented by the Group through pseudo-*case law*, has a *para*-law function, as it is used as a permanent alternative to the hard-law harmonization which the Member States wish to avoid. To the extent the Code is implemented through agreed soft law *policies*, which qualify as pseudo-*legislation*, it also has a *pre*-law function, as in some cases, these agreed common policies serve as a forerunner to legally binding solutions, such as the anti-tax avoidance directives (ATAD 1 and 2) and the inclusion of the obligation to automatically exchange cross-border rulings in the directive on administrative cooperation between the Member States (DAC 3).

Also, this study concluded that the Code is a manifestation of the Open Method of Coordination (OMC). It clearly contains most of the paradigm OMC-features, notably: guidelines; worst practice definitions (harmful tax practice criteria; see Section 6) and best practice definitions (common soft law tax policies; see Section 7.2); benchmarking; agreed principles and criteria; time-tables; periodic monitoring and evaluation; and peer review, if necessary in the form of naming and shaming. Its implementation through pseudo-case law (see Section 7.1) has resulted in the dismantling of many harmful tax regimes, contributing to the convergence of Member States' national rules, which is an important goal of the OMC. Convergence in the field of pseudo-legislation (see Section 7.2) has so far been limited, however, and which was, moreover, often poorly implemented by Member States.

While there are many similarities in both the characteristics and the convergence objective between the Code and the OMC, three important OMC-features/objectives seem to lack, however: transparency, involvement of stakeholders and involvement of national parliaments. This shows that the political logic of the Code does not fit well with other major OMC-goals, such as participatory governance and social learning. Stakeholders in the public tax avoidance debate, including the business community, non-governmental organisations and academia, and even parliaments have so far been largely kept away from the work of the Group.

4. The governance and working methods of the Code of Conduct Group (*Chapter 4*)

This study analyzed and evaluated the governance and working methods of the Group, as well as the level of involvement of stakeholders in the Code's decision-making process. The Code of Conduct Group reports to the Council, formally through the diplomatic *Comité des Représentants Permanents* (Coreper), bringing together Member States' ambassadors, but in practice, the Group mostly takes political decisions itself. Reports and draft Council Conclusions prepared by the Group are generally adopted by the Council without discussion. Only occasionally unresolved Code-issues are debated by Member States' Finance Ministers, but recent initiatives seek to increase the Council's political involvement.

The Group consists of representatives of the Member States, the Commission and the Council Secretariat. In the early years, senior officials closely linked to Member States' Finance Ministers attended the Group's meetings, but over the past fifteen years, Member States have often sent delegates at a more technical level. As the work has become increasingly delicate and complex over the past decade, especially due to the increased focus on the development of soft law policies for general competition sensitive tax issues, this study considers it feasible that Member States are represented at a politically higher level, as also foreseen in the Group's

operating rules. The common BEPS-challenges currently facing, the Group would seem to deserve and require politically strategic decision-making.

This study also showed that although the weight of the so-called Preparatory Group - consisting of the Chair, the two Vice-Chairs and representatives of the Commission and the Council Secretariat - is unclear, a proposal (2015) from the G5 Member States to strengthen its preparatory capacity underlined that its impact on decision-making should not be underestimated. As of 2019, the Group is supported by two SubGroups, one for internal affairs (intra-EU matters) and one for external affairs (third-country matters). This should allow for more in-depth technical discussions at SubGroup level, allowing the Group itself to focus on general, procedural and strategic Code-issues. There was little political appetite for the G5-proposal for a revised governance structure, consisting of a Chair with high-level political leadership and a direct link to the Ecofin Council.

The General Secretariat of the Council is the Group's secretariat. It supports the Group in procedural matters, from organising and coordinating its meetings to advising the Group's Chair both tactically and substantively. As Secretariat officials generally enjoy a high level of trust and respect from Member States, their influence on decision-making may be significant. Although the Commission has no formal vote in the Group, and its role is formally of a facilitating - technical - nature, its independent, advisory and roll-back supervisory role has been of great significance for achieving tangible pseudo-case law and pseudo-legislation results. Despite not being formally involved in the Code's decision-making process, the European Parliament's investigation committees (TAXE 1, 2, 3) have been successful in influencing the work, governance and operation of the Group.

The Group's decision-making is shown to be based on a 'broad consensus' principle; i.e., in fact a quasi-unanimity rule. The Group is able to agree on a particular file even with one, two, or even three dissenting Member States. In such cases, the Group's report to the Ecofin Council mentions that 'the Group agreed', but dissenting opinions are reflected in footnotes. Dissenting Member States have the chance to prevent the adoption of the report at Council level, where decision-making takes place by unanimity, but this study showed that, in reality, they rarely did.

Nonetheless, an analysis of the Group's work also showed that at times it was difficult or impossible to reach broad consensus, resulting in certain forms of harmful tax competition not being adequately addressed (see Section 7.1). Recent proposals to abandon the broad consensus rule have been strongly criticised by several Member States. However, the Group agreed (2016-2017) to involve the Ecofin Council more systematically in its work, in particular where broad consensus on the harmfulness of an individual tax regime or on the drafting or monitoring of a soft law policy proves unattainable. It was also agreed to encourage the Ecofin Council to debate strategic Code-matters. However, this study concluded that neither of these initiatives has produced much follow-up until now.

Member States still strongly adhere to the Group's diplomatic character, being convinced that the Group cannot function adequately if confidentiality is not guaranteed, but persistent criticism of particularly the European Parliament on the Group's lack of transparency and opaque working methods prompted the Member States to agree on initiatives for increasing the Group's transparency and strengthening and formalizing its working practices. This study concluded that publication of more detailed public progress reports and of agreed descriptions and final assessments of national tax regimes has improved public accountability. By contrast,

transparency of pseudo-legislation decision-making and implementation has barely improved. A recent proposal tabled by the Netherlands to actively publish pseudo-legislation proposals - like legislative proposals of the Commission - has been dismissed by a large majority of Member States. Likewise, there appeared little support for the Dutch proposal to produce and publish a detailed report after each meeting.

This research further showed that the standstill and rollback notification and the assessment procedure have recently been refined and made more transparent. Where most Member States attach considerable importance to having their tax regimes cleared by the Group, there have also been instances where information on harmful practices only came to the attention of the Group after notification by (anonymous) other Member States or by the Commission. Clear and objective criteria in the new guidance should ensure that Member States fully respect their standstill and rollback obligations. Working methods have also been strengthened and formalised to ensure more effective monitoring of Member States' compliance with pseudo-legislation and other soft law adopted by the Group. In the past, both large and small Member States often did not implement agreed common policies adequately (see Section 7.2).

5. The geographical scope of the Code (*Chapter 5*)

The Code's geographical scope is very broad, which has contributed to the dismantling of many preferential tax regimes worldwide. It applies within the geographical scope of the Union Treaties, which means that Member States, their Outermost Regions (OMR's) and European territories whose external relations are the responsibility of a Member State (currently only Gibraltar) are integrally subject to the Code. But the Code's geographical scope reaches further than EU-territory: in accordance with its geographical extension clause, its principles must also be respected in territories other than those to which the Treaties apply, in particular in Member States' Overseas Countries and Territories (OCT's) and in some small islands with a special connection to a Member State. As regards this latter category, this study showed that the Group's work in relation to the British Crown Dependencies is particularly salient. This study concluded that the Group has been quite successful in promoting the Code's principles and criteria vis-à-vis third countries. Notably, the dialogue with two neighbouring third countries, i.e., Liechtenstein and Switzerland, and impressive recent work on an EU tax haven blacklist, have led to the repeal of many harmful preferential tax regimes outside the EU.

6. The substantive scope of the Code (*Chapter 6*)

Based on an analysis of the Code, its *travaux préparatoires*, the Group's pseudo-case law, and recently published working practices, this study identified the following four-step approach generally followed by the Group in assessing whether a national preferential tax regime is compatible with the Code:

Step 1: Is the tax regime within scope?
The tax regime must be a business taxation measure that significantly affects, or may affect, the location of business activities in the EU. Contrary to what one would expect, this study demonstrated that the question of significant impact seems to play only a limited role in assessments of national regimes. Only occasionally, this element has been considered under step 4, at specific request of a Member States in an attempt to convince the Group that its regime should not be considered harmful. This research made clear that the Group seems to assign

most importance to the question of whether the regime is a 'business taxation' measure. This term, which mainly includes taxes levied on business profits at company level, is interpreted broadly. Personal income taxation falls in principle outside the Code. Member States and the Commission have argued that preferential regimes for employees and wealthy individuals needed to be dealt with by the Group, either within the existing mandate or by formal extension of it, but so far, they did not have any success. Although clearly covered, this study revealed that EU shipping regimes and EU investment fund regimes have so far been left aside.

Step 2: Is the tax regime potentially harmful?
To answer this question, the gateway criterion is decisive. It prescribes that the regime must provide for a significantly lower effective level of taxation compared to the normal level of taxation under the benchmark tax system. It operates as the standalone indicator for the identification of a potentially harmful regime, the assessment criteria (step 3) featuring as additional indicators for evaluating whether it is also factually harmful. This study underlined that the gateway criterion is crucial, because, from a Code-perspective, there is in principle nothing wrong with a competitive (very) low standard corporate tax rate. The Group has approved several mainstream zero rate tax systems, most notably those of British Crown Dependencies. A problem only emerges when the measure departs from the benchmark tax system, mainly in favour of highly mobile activities. That this condition should not be interpreted restrictively is demonstrated by the fact that participation exemption regimes and NID-regimes are considered to fulfil this test. Finally, this research showed that proposals (2015-2019) of the Commission and several Member States to formally extend the gateway criterion, covering measures and administrative practices that provide for a level of taxation below a particular (effective) tax rate have proven controversial.

Step 3: Is the tax regime actually harmful?
This study showed that for the evaluation of the factual harmfulness of a potentially harmful tax regime, the Group considers the following non-exhaustive list of assessment criteria:

- *Ring-fencing I*: the tax advantage is *de jure* or *de facto* only or mainly available to non-residents or in respect of transactions carried out with non-residents (off-shore characteristics). This study showed that this criterium consists of two alternative elements/assessments; i.e., a *de jure* assessment, which involves a legalistic interpretation of the rules attached to the regime, and a *de facto* assessment, which analysis the real effect of the regime.
- *Ring-fencing II*: the domestic market is *de jure* or *de facto* protected against the tax advantage, ascertaining that the advantage does not erode the existing domestic tax base of the Member State concerned, but only (negatively) affects the mobile tax base of other countries. Likewise, this criterium consists of similar alternative elements/assessments.
- *Substance criterium*: the granting of the tax advantage irrespective of a real economic activity and irrespective of substantial economic presence of the taxpayer in the Member State concerned. This research demonstrated that the real economic activity test (which considers the nature of the activity that benefits from the regime) forms the basis of the assessments. The substantial economic presence test (which focusses on the factual manifestation of the activity that benefits from the regime) is applied if there is uncertainty as to whether the real economic activity test is met (e.g., in the case of highly mobile activities). Additionally, the Group recently agreed that all regimes should henceforth meet the 'nexus test', requiring that there should be an adequate *de jure* and *de facto* link between real economic activity carried on by the companies benefitting from the preferential treatment and the profit for which that tax treatment is granted.

- *Profit determination criterium*: the rules for the determination and allocation of profits within an international group of companies depart from internationally accepted standards, especially the arm's length principle, but also the profit allocation principle for permanent establishments, the symmetry principle (exemption of profits only if also losses are non-deductible), etc.
- *Transparency criterium*: the regime is not (fully) published in legislation or guidelines and/or subject to administrative discretion. This study revealed that the following three factual tests are applied: is the regime (i) set out in legislation?; or (ii) otherwise fully published in the form of regulations or guidelines?; or (iii) subject to administrative discretion? The first two tests target non-transparent tax practices offering preferential treatment on a case-by-case basis (unpublished practices derogating from statute law), and the third test identifies tax practices leaving room for administrative discretion.

This research has made clear that the main question for the Group is how to apply these assessment criteria to different types of preferential tax regimes. By drawing up guidelines, most recently on NID-regimes, the Group seeks to address this issue.

Step 4: Is the harmful tax regime nevertheless justified?
This research concluded that a range of diverse criteria and factors have periodically played an important role as a justification to exclude, at the request of a Member State, a regime from being assessed harmful by the Group, including:

- *written justifications (market justifications)*; i.e., (i) the absence of harmful effects on other Member States' economies and (ii) necessary support for the economic development of certain regions (*underdevelopment justification*).
- *unwritten justifications (competitiveness justifications)*.
- *precedence*; Member States have periodically – with varying degrees of success – claimed equal treatment on the basis of a similar tax regime of another Member State already approved by the Group in the past.

7. Evaluating the work and effectiveness of the Group (*Chapters 7 and 8*)

This study concluded that the work of the Group on blacklisting and phasing out harmful tax regimes (pseudo-case law; one-country issues) and on common tax policies for competition sensitive tax issues (pseudo-legislation; two-or-more-country issues) have clearly (i) converged Member States' tax systems; (ii) reduced many internal market distorting regimes, and (iii) contributed to a more transparent and fairer tax landscape within the EU. Moreover, it concluded that both the Group's pseudo-case law and its pseudo-legislation can be considered to form part of the *acquis communautaire*, which cannot be disregarded by (future) Member States and their dependent or associated territories, nor by third countries in their relations with the EU. This study further observed that in many cases the Code's political signature has probably played a positive role by providing flexibility and momentum for achieving results, but also that the work of the Group experienced many setbacks and that several tax policy issues remain unresolved. In the next Subsections, category-specific conclusions are presented on the Group's work and effectiveness in the areas of pseudo-case law (Section 7.1) and pseudo-legislation (Section 7.2).

7.1 Pseudo-case law (*Chapter 7*)

An analysis of the Group's documents made available to the author shows that the Group has been successful in the rollback of many - often not very transparent - national preferential tax regimes of Member States, their dependent or associated territories, and even third-countries, particularly after the recent drawing up of the EU tax haven blacklist. It demonstrates that the Group's pseudo-case law restricts Member States' tax sovereignty as States and that their dependent territories must respect the limits outlined by the Group when introducing new tax regimes. At the same time, the Group's pseudo-case law has provided more clarity and certainty for business and more stability of the investment climate in the EU. All Member States have to stick to the agreed pseudo-legal principles, and their compliance to the Group's decisions appears satisfactory.

The Group's pseudo-case law often does not state clear reasons why individual national tax regimes have been accepted or found harmful. For most *types* of regimes, however, it provides pseudo-legal principles, which can be used as a benchmark by Member States when introducing new tax regimes. The Group has accepted many regimes providing for a significant lower effective tax rate than the standard rate for specific types of income (e.g., intellectual property income, interest income, capital gains, deduction for equity, liquidation losses, etc.). Like the State aid prohibition, the Code thus allows Member States a certain discretion to tax a specific type of income, sector or region at a lower effective rate without automatically leading to disapproval.

This study derived the following category-specific conclusions from the Group's pseudo-case law:

- *Generic corporate tax regimes* have been considered harmful where specific types of passive income (e.g., interest or royalties) were effectively taxed at a significantly lower level than the standard rate.
- *Shareholder tax regimes* have been labelled harmful where the combination of the general corporate tax system and the shareholder tax regime provided a significantly low(er) effective tax level on foreign investors' business profits, while that combination at the same time ensured taxation of existing domestic business profits at the standard tax rate, producing *de facto* ring-fencing.
- *Interest regimes* for non-conduit situations offering preferential treatment for intra-group interest income and/or interest expenses are not harmful *per se*. However, they are harmful if the domestic tax base is protected (ring-fenced) in any way, particularly where the regime only benefits transactions with non-residents and, therefore, is not open to domestic-source intra-group interest income.
- *NID-regimes*, either equity stock-based or incremental, are accepted methods to reduce the indebtedness of (multinational) companies and to improve their debt/equity ratio by reducing the fiscal bias against equity financing. Both types of regime, however, run the risk of being considered harmful if they are not equipped with an adequate anti-abuse framework to prevent tax avoidance through intra-group transactions.
- *Intellectual property regimes*, either front-end (cost) based or back-end (income) based, are considered acceptable methods to promote research and development. Considering the importance of a prosperous innovation sector in the EU, the Group embraced front-end regimes as an effective policy instrument for boosting research and development, which are in principle not harmful as they are budget-limited, i.e., based on the research and development expenditures actually incurred and by nature require economic substance and presence. The picture regarding back-end regimes, notably patent boxes, is slightly different. Recent pseudo-case law reaffirmed that patent boxes are accepted if benefits are only granted in case of genuine economic activity. They need to be in line

with the OECD/BEPS modified nexus approach, which requires a strong territorial connection between the research and development costs incurred to develop a patent or know-how and the profits made by that patent or know-how to which the regime may be applied.

- *Insurance company regimes* are harmful if they (i) allow for the creation of a tax-exempt risk reserve which does not correspond to the real and usual business risks of insurance companies or (ii) provide for a partial or complete exemption from corporate income tax or a reduction in the tax base for insurance profits.
- *Holding company regimes (participation exemptions)* are acceptable methods to avoid international economic double taxation of distributed company profits. Such regimes, however, are not accepted if they (i) are not equipped with an appropriate anti-abuse framework, such as effective CFC-legislation or a switch-over provision (from exemption to credit) with a 'subject-to-tax'-clause, and/or (ii) are not symmetric by allowing deduction of capital losses whereas capital gains are exempt. In specific circumstances, however, asymmetry may be accepted (carve-out), such as the recognition of a liquidation loss.
- *Group coordination regimes* applying the cost-plus method or other accepted transfer pricing methods to determine the taxable profits of a (group coordination) company are in principle also accepted. Unacceptable, however, are administrative practices (i) applying the cost-plus method even where a comparable uncontrolled price is available; (ii) granting standard rulings containing fixed cost-plus margin rates; and/or (iii) providing reductions of the cost-plus base. The Group requires all costs to be included in the cost-plus base and rulings to be issued on a case-by-case basis in accordance with the arm's length principle and international transfer pricing standards and, as well as regular reviews of the applicable cost-plus margin rate against normal commercial criteria.
- *Intermediate group finance and license company regimes* are considered incompatible with the Code where they are applied as an administrative practice of fixed interest/royalty spread rulings for back-to-back loans/royalty payments. Here too, the Group requires rulings for intra-group financing or licensing activities to be issued on a case-by-case basis and condemns standard rulings with fixed margins and/or without expiration date or with automatic renewal. Also, it requires the publication of the policy and the procedure for granting such financing and other APA-rulings and the exchange of information on such agreements with other member States.
- *Foreign finance branch regimes* have been considered harmful where (i) the division of finance profits between head office and the foreign branch was based on a standard formulaic profit allocation ruling and/or (ii) the finance branch profits were exempt in the head office State although the branch profits were taxed at a very low rate.
- *Informal capital regimes* have been found harmful were (i) (APA-)rulings were routinely issued setting the unilateral downward adjustment too high (lack of arm's length dealing) and/or (ii) they created an international mismatch, meaning that a unilateral downward adjustment leading to a tax deduction in one Member State was unlikely to be compensated by a corresponding additional tax in the other Member State involved. To be Code-compliant, any informal capital must be determined at arm's length conditions and relevant information on the rulings issued should be exchanged with other Member States.
- *Free zone regimes* are in principle accepted by the Group. Such regimes, however, will be considered harmful where (i) the free zone permit issued does not require economic substance/presence, as activities such as production or distribution involve economic substance, (ii) tax benefits are granted for internationally highly mobile activities such

as banking/insurance, intra-group services and holding activities and/or (iii) the procedure and conditions for obtaining free zone permits are not clearly defined in public legislation and/or the permission to operate in the free zone is subject to discretion.

This summary shows that the Group has achieved impressive results in tackling many different types of preferential measures and administrative practices, but the political nature of the Code and the Group's 'broad consensus' decision-making has also led to the bogging down or blocking of decision-making. There still are, therefore, loose ends in the form of inconsistent and unsatisfactory results, some forms of unfair tax competition not having been adequately addressed. This study observed the following inconsistent or unsatisfactory results/trends:

Trend 1: Allowing apparently harmful precedents as benchmarks
In several areas, such as interest regimes, patent box regimes, and NID-regimes, measures have been accepted that included features that justified a 'harmful' assessment. The main reasons for these inadequate outcomes were (a combination of):
- stalling off or blocking of decision-making by certain Member States;
- lack of adequate information on how international mobile taxpayers exploit national regimes in tax planning structures.
- lack of momentum and lack of peer pressure to fully comply with the Code.

The fact that the Group accepted several regimes, which in hindsight should have been found harmful, created 'harmful precedent benchmarks'. At times, Member States have relied on these false benchmarks when introducing new incentives to seduce international groups to relocate their mobile activities to their jurisdiction. Because these new and sometimes even more beneficial regimes were based on an accepted precedent, it was difficult for the Group to judge these regimes on their own real merits. On the other hand, precedents do not necessarily imply future approval or continuation of approval. Regimes previously approved have been re-assessed in exceptional circumstances, especially where the OECD/BEPS project required action, for instance in the case of the OECD stipulation of the modified nexus approach for R&D tax breaks. Sometimes, the Commission neutralized unwelcome harmful precedents by issuing a negative State aid decision (see Section 8).

Trend 2: Condoning continuation of tax regimes labelled 'harmful'
There have been instances where a national regime was found harmful, but rollback was inadequate. Generous transitional arrangements were requested and allowed for blacklisted regimes, the monitoring of Member States' compliance with their rollback commitments was poor at times, and no clear condemnation in the form of public naming and shaming followed in cases of non-compliance: violations of rollback obligations were not published in public reports of the Group or in Council Conclusions. This study identified the following inadequate compliance with rollback obligations:
- *continuation of blacklisted regimes by rulings.* In at least two cases, jurisdictions continued their blacklisted regimes by issuing non-transparent harmful rulings to certain taxpayers. Remarkably, both cases of clear violation of Group decisions do not seem to have attracted a clear condemnation by the Group or by the Council. Non-transparent continuation of harmful practices is by its nature very difficult to detect and therefore may well have occurred more often. Only rarely, information on such practices becomes public, for instance by leaks of whistle-blowers to the press such as the LuxLeaks affair (2014). With the recent adoption of mandatory automatic exchange of information on tax rulings and mandatory disclosure of potentially harmful aggressive tax planning arrangements, Member

States will be in a better position to detect such harmful practices of other Member States and notify them to the Group.

- *continuation of harmful features of blacklisted regimes*. In several cases, Member States failed to fully implement their rollback obligation as a consequence of which harmful features of the regime persisted. Although the reasons for such limited compliance were sometimes understandable, they have not been helpful for Code-compliance in general. Also, Member States sometimes covered each other's backs, resulting in weak and inadequate rollback compromises.
- *no timely rollback of blacklisted regimes.* In some cases, not only existing beneficiaries were able to continue to benefit from the harmful regime for a substantial period, but also new entrants were allowed even after the agreed cut-off date. This occurred in the early years of the Group but also recently, where the patent box regimes of several larger Member States remained open for new entrants after the agreed cut-off date. While the Group reported this clear non-compliance to the Council, the latter did not take effective action.
- *too generous transitional arrangements for blacklisted regimes*. In some cases, very generous transitional arrangements for existing beneficiaries of harmful regimes were negotiated by Member States, sometimes up to ten years, clearly going much further than necessary for the observance of legitimate expectations of the beneficiaries.

Trend 3: Inconsistent double standards

At times, the Group seems to have applied double standards: regimes of neighbouring third countries, such as notably Liechtenstein and Switzerland, seem to have been tackled more resolutely than comparable regimes applied by Member States or their dependent or associated territories, or by other third countries. This is illustrated by the Group’s decision in 2019 to leave out participation exemptions categorically from the EU tax haven blacklist, which seems to create an unlevel playing field between Liechtenstein (its participation exemption was blacklisted in 2017) and other third countries. While Member States' dependent and associated territories clearly fall within the scope of the Code *and* the EU blacklist exercise, their participation exemptions have not (yet) been investigated. This may lead to unequal treatment and to inadequate addressing of harmful regimes, which both do not add to the credibility of the Group's work.

Trend 4: Allowing low rates, harmful general regimes, and mismatches

The Group's work has encouraged Member States to compete with generic tax base regimes and general low rates, offering low taxation for in principle all companies. As the Code was not aimed at removing all tax competition, but only at removing harmful preferential tax regimes violating the Code’s principles and criteria, one might consider this trend a fair result. However, this research revealed several instances where jurisdictions introduced regimes, sometimes entire tax systems, that were arguably outside the scope of the Code, but which could well be considered harmful in effect:

- *tax competition by generic tax regimes* exempting certain types of income (e.g., passive interest and royalty in one case) has led to intense and lengthy debates in the Group on fundamental topics, including coverage issues. Features of such regimes have been assessed as harmful in cases where they were considered similar to regimes granting preferential tax treatment for low or no substance offshore companies, which have been consistently found harmful by the Group. In several situations, however, apparently ‘harmful’ features could not be adequately addressed under the Code, sometimes prompting the Commission to tackle them on the basis of the State aid prohibition (see Section 8).
- *tax competition by very low or zero tax rates*. Several jurisdictions introduced mainstream zero tax rate systems combined with shareholder regimes, adding a layer of (personal)

taxation at the level of resident shareholders for deemed dividend payments. These schemes, which were arguably outside the material scope of the Code as they concerned taxation of individuals, ensured zero effective taxation on foreign investors' business profits, while the low level of taxation was not available for domestic individual shareholders. While these and other shareholder regimes were nevertheless considered harmful, and consequently had to be dismantled, one might question whether the outcomes of these cases are satisfactory, as agreed rollbacks often allowed the continuation of very low or zero tax rates.

- *tax competition by non-transparent hybrid mismatch practices.* This study showed that in the past twenty years some Member States actively created hybrid mismatch opportunities by exploiting differences in tax systems (disparities) between Member States, leading to double non-taxation. The Group eventually agreed to make this issue a stepping stone towards tax coordination, which led to the adoption of several impressive coordinated taxation policies for hybrid mismatches (see Section 7.2) that paved the way for the legally-binding anti-abuse measures adopted ten years later (ATAD 1 and 2).
- *tax competition by non-transparent transfer pricing mismatch practices*. This study concluded that the Group has not been very successful at addressing mismatches resulting from Member States' divergent national infocap regimes. Like hybrid mismatches, transfer-pricing mismatches may be considered the unfortunate result of disparities, for which no specific Member State is to blame. This issue requires coordination, i.e., pseudo-legislation, or hard law harmonization rather than pseudo-case law. Nonetheless, tax competition by actively offering opportunities to exploit tax disparities through informal capital rulings, may in some cases no longer be considered a mere unfortunate outcome, but rather a deliberate attempt to design *de facto* preferential regimes that are harmful in Code's spirit. This study showed that although Member States are now legally obliged to exchange information on cross-border transfer pricing rulings automatically, that does not mean that all mismatches will be eliminated. Indeed, it is doubtful whether the other Member State concerned will in all cases recognize the need to make a corresponding adjustment, if its legislation allows it to make such an adjustment in the first place, as the very issue is a legislative or judicial *mis*match. The Commission is currently investigating several transfer pricing mismatches under its State aid powers, but it remains to be seen whether these cases represent unilateral State aid or merely disparities between Member States' arm's length adjustments policies. If these investigations do not lead to negative decisions, the Group could consider to re-assess all info-cap ruling practices or, more ambitiously, to develop a common transfer-pricing policy for such mismatches, possibly jointly with the EU Joint Transfer Pricing Forum.

7.2 Pseudo-legislation (*Chapter 8*)

This study found an increasing importance of designing common policies in addition to assessments of individual measures. The Group increasingly aims to reduce tax avoidance by multinational companies and the facilitation thereof through harmful tax competition by developing common taxation policies. The assessment of individual Member States' preferential tax regimes revealed overarching tax policy issues that could only be tackled in a coordinated way by adopting and implementing real soft law by all Member States, not by mere rollback of specific measures of individual Member States. These soft law policies may be qualified as 'pseudo-legislation'. The Group has adopted:

- *common policies on the exchange of information on tax rulings (2003-2014; converted into hard law in 2016)* aimed at ensuring that Advance Pricing Agreements (APA's)

and cross-border tax rulings would not lead to double non-taxation by requiring Member States to spontaneously exchange information on rulings. These policies were largely ignored by Member States, necessitating the adoption of the hard law (see trend 3 below).

- *common policies for a good tax ruling practice (2010-2016; implementation currently monitored by the Group)*, the most striking and detailed pseudo-legislation is the 2016-agreement on common standard requirements for a good and transparent tax ruling practice, containing detailed requirements as regards: (i) the procedure for obtaining advance legal certainty by taxpayers; (ii) the term of validity of rulings issued; (iii) the monitoring of the correct implementation of rulings (audit and review and renewal procedures); (iv) exchange of information on rulings issued; and (v) publication of rulings.
- *a common policy for EU-inbound profit transfers (2010; converted into ATAD 1 in 2016)* requiring every Member States to perform a 'gatekeeper' function with regard to companies receiving intra-group dividends from non-EU subsidiaries. Member States' participation exemptions should contain effective anti-abuse provisions in the form of either a switch-over clause or effective CFC-rules.
- *common policies for international hybrid mismatches* (2008-2016; converted into ATAD 1 (2016) and ATAD 2 (2017)) offering solutions for both intra-EU and third-country hybrid-financing, hybrid-entities and hybrid-permanent establishments mismatches.

This study concluded that the Group's production of pseudo-legislation was quite impressive and offered – eventually hard law – solutions for major tax competition issues, but also showed that work in many cases proved very difficult, leading to inconsistent and unsatisfactory results. This study observed the following trends:

Trend 1: Member States (large and small) have frustrated the development of certain soft law policies, leading to deadlocks, weak political compromises and the blocking of anti-tax avoidance solutions
One of the most frequently used arguments by these Member States was that the drafting of pseudo-legislation was outside the Group's mandate, even though Paragraphs K and L of the Code clearly open the possibility to agree on common policies for general tax policy issues and future BEPS-like issues. Also, Member States argued that policy coordination encroached unacceptably on their tax sovereignty. Other recurrent objections concerned the view that hard law was necessary rather than a political solution, or the impossibility to agree with a soft law policy because of upcoming elections at home. Whether these objections were real concerns to the obstructing Member States or mere containment politics often remained unclear. Some of these cases resulted in a softened political compromise, in spite of many Member States and the Commission favouring a more detailed soft law policy. This occurred in the areas of EU-inbound profit transfers and hybrid mismatches. Some other cases are still in an impasse, as a result of which a significant amount of work on EU-outbound payments has not yet resulted in any common policy. The same is true for work on transfer pricing issues.

Trend 2: Soft law policies were often not effective until they became hard law
This study showed that soft law in the area of exchange of information on tax rulings, EU-inbound profit transfers, international hybrid mismatches, and some of the common tax ruling policies, clearly lacked effectiveness. Several explanations have been offered for this. The Group often omitted specific implementation rules/dates for agreed policies. Also, political agreements were often not adequately monitored by the Group. Where monitoring was

eventually initiated, it turned out that Member States, large and small, often relied on the mere political signature of the agreements to duck their implementation obligations or to frustrate the monitoring process, for example by not providing the Group with the requested necessary information in a timely and complete manner. Consequently, in many cases, it was difficult for the Group to come to a sensible judgement regarding Member States' compliance with the agreed common policies. Moreover, the sometimes rather vaguely framed Member States' political commitment(s) offered room for vague compliance. A final important explanation is the lack of clear condemnation even where a non-compliant Member State was caught red-handed: there was no naming and shaming, neither in the Group's public reports, nor in the public Council Conclusions.

Trend 3: Soft law policies were sometimes a forerunner for legally enforceable solutions
This research demonstrated that pseudo-legislation not very enthusiastically complied with has, nonetheless, sometimes served as a forerunner for legally binding measures notably in the areas of exchange of information on tax rulings, EU-inbound profit transfers, and international hybrid mismatches. Conversion into hard law often appeared necessary to realize the objectives politically agreed upon. However, it remains questionable whether these conversions would have occurred without the momentum created by the LuxLeaks-affair and the OECD-BEPS-project.

Trend 4: Soft law policies sometimes supplement hard-law solutions
The implementation of legally binding EU anti-tax avoidance rules raises the question of whether political agreements within the Group have much prospect in the area covered by directives. The conversion of non-respected soft law into hard law obviously significantly reduced the relevance of that soft law, but this study concluded that the Group's soft law may still complement hard law in specific circumstances, and therefore remains relevant. Where the DAC 3 requires exchange of information only on 'cross-border' APA's and tax rulings, the broad material scope of the Group's pseudo-legislation in this area requires Member States to spontaneously exchange information also on 'domestic rulings' in so far as they may significantly influence the location of business activities in the EU. Time will tell whether Member States will respect this residual merely political exchange of information commitment. Additionally, the Group agreed that the implementation of the legally binding CFC-rule contained in ATAD 1 by all Member States would render work on EU-inbound profit transfers obsolete, but it seems questionable whether ATAD 1 will ensure effective taxation of EU-inbound profit transfers in all cases, as required by the Group's 2010-pseudo-legislation. This is, first, because the optional transfer-pricing approach of the CFC-provision in ATAD 1 is considered too weak to combat BEPS-issues effectively. Second, Member States currently have no legal obligation to apply an effective switch-over from exemption to credit, as the switch-over clause proposed by the Commission did not make it into the final version of ATAD-1. The residual soft law on this issue may, therefore, backed by the new CJEU judicial policy of *requiring* Member States to combat abuse of EU law even in the absence of a national legal basis, lead to extra-ATAD obligations for Member States to effectively tax EU-inbound profit transfers.

Trend 5: Work on soft law policies has been made redundant by case law of the CJEU or may be produced by that case law
The lack of consensus on the need for coordinated action as regards EU-outbound payments (see trend 1 above) has recently been overcome by landmark decisions of the CJEU in the Danish 'conduit companies'-cases holding that Member States must levy a withholding tax in accordance with their national legislation in case of abusive EU-outbound payment practices

relying on EU Directives, even if no anti-abuse provision has been implemented in national law, as the general EU-law principle of the prohibition of abuse of law requires them to do so. To avoid inconsistent application by Member States' national courts of the CJEU's indications on the existence of an abusive practice in a specific case, it may be helpful if the Group develops guidance in the form of a common interpretation of the Danish cases for specific types of cases. Such guidance could have a similar interpretative value as the official OECD Commentary to the OECD Model Tax treaty. It could, on the one hand, identify the abusive EU-outbound payment practices that Member States have to address, and, on the other hand, provide international business with safe haven guidance. Because the Danish cases seem equally relevant to EU-*in*bound profit transfer practices, it may be helpful for the Group to examine whether additional work is needed in this policy area as well.

8. Interaction between the Code (soft law) and hard law (*Chapters 7 and 9*)

This study showed that the Member States may have agreed on the Code to keep the Commission from using hard law, particularly the State aid prohibition (Articles 107 and 108 TFEU), but possibly also the market distortion rules (Articles 116 and 117 TFEU). A non-legally binding Code could create a win-win situation for all stakeholders: by cleaning their tax systems themselves through an OMC forum, Member States retained their much-cherished tax sovereignty, while this saved the Commission considerable State aid and market distortion investigation efforts.

This research concluded that the stick of hard law has apparently been quite effective in convincing reluctant Member States to eliminate blacklisted measures and administrative practices. While the State aid prohibition and the Code coincide to a large extent and pursue the same objective of reducing internal market distortions, they are certainly not identical in scope. Their criteria overlap but are not identical, and the geographical scope of the Code is much wider than the State aid prohibition scope. Where the Commission considered the Group's work unsatisfactory, it used the State aid prohibition to ensure a better result. As a result, the (threat of the) State aid rules have supported the Code work in many areas, notably in the field of interest regimes, insurance company regimes, intermediate group finance and license company regimes and group coordination regimes.

The increasing use by the Commission of its State aid powers to address questionable tax rulings granted by Member States to international companies suggests that the Commission is not very satisfied with the Code Group's results anymore. The Commission launched its investigations in the wake of the Luxleaks affair (2014) and other tax avoidance affairs showing that not all Member States honoured their political commitment to notify potentially harmful tax rulings to the Group and to exchange information on such rulings with other Member States (see also trend 1 in Section 7.1). Also, political and societal criticism on the Commission for failing to enforce EU law as Guardian of the Treaties seems to have triggered the use of the State aid rules.

The European Parliament is further urging the Commission to also use the market distortion provisions to tackle tax avoidance and tax competition. This study made clear that theoretically, i.e., legally, this hard law could complement the Code in addressing national preferential regimes of Member States (pseudo-case law; see Section 7.1) which use or create disparities, and which the Group does not succeed in prohibiting or rolling back. If a small number of Member States blocks an otherwise unanimous decision condemning a harmful measure, the

Commission could use the anti-distortion procedure to address that tax regime, if necessary by submitting a special directive proposal to the Council and the Parliament. The use of the market distortion rules would be justified, because (i) one single or only a few Member States cause the fiscal market distortion; (ii) the distortion is clearly significant and cannot wait to be eliminated by adoption of very speculative and uncertain future comprehensive direct tax harmonization; and (iii) it can be eliminated/avoided by unilateral adaptation of the law or practice of the Member State(s) involved. The elimination of the distortion would then function as a mini-harmonisation as it is limited to one Member State, but other Member States would have to take it into account in their future tax policy.

This study also identified that in reality, i.e., politically, it is not very likely that the market distortion rules will be engaged successfully against one or a few Member State(s). Most Member States probably will vote against such a legislative proposal, not because of disagreement with its content, but to avoid the anti-distortion weapon to be turned against themselves in future. There are not many Member States which do not cherish their fiscal veto right. Also, this study shows that the Commission still interprets the notion of market distortion in Articles 116 and 117 TFEU largely as narrow as the Spaak (1956) report did some sixty years ago, even though it somewhat relaxed the requirements for their application in its 1991 market distortion policy note. Furthermore, this study concluded that the free movement rights and the State aid prohibition, whose scope overlaps with the scope of the – subsidiary – market distortion rules, already ensure elimination of many market distorting tax regimes of Member States. Additionally, by slowly cleaning their corporate tax systems themselves in the Code of Conduct Group, the Member States take away the necessity for the Commission to rely on the market distortion rules.

Finally, the market distortion rules seem not appropriate as an alternative or a complement to Code in addressing general competition sensitive tax issues (pseudo-legislation; see Section 7.2). Such very generic tax distortions cannot be imputed to one or only a few Member State(s). Where a small group of Member States fails to implement common tax policies agreed within the Code Group (pseudo-legislation), this non-observance cannot simply be addressed under the market distortion rules given the primacy of the direct tax harmonization provision (Article 115 TFEU). Allowing direct tax harmonization on the basis of the market distortion rules would undermine the unanimity rule in direct tax matters.

9. Outlook

The work of the Code of Conduct Group, leading to both an impressive body of pseudo-case law and common policies which may be qualified as pseudo-legislation, backed by Commission State aid investigations, have changed tax competition between Member States from difficult-to-spot tax base reductions to more transparent tax rate competition, and from an endless playing ground of discretionary and non-transparent administrative practices benefitting mobile and/or off-shore taxpayers to a more narrowly defined level playing field where the rules of the game require substance, presence, nexus, transparency, automatic exchange of information and anti-abuse measures. National tax bases have been broadened, and statutory tax rates have come down. The downside is that the in itself impressive work of the Group has also contributed to a tax rate race to the bottom and to ‘smart’ tax competition based on exploitation of transfer pricing and (hybrid) mismatches resulting from disparities between member States’ transfer pricing approaches for which no particular Member State may be blamed separately. Hybrid mismatches have therefore been addressed by the ATAD 1 and 2 directives. Transfer pricing

disparities still persist, but the Commission tries to curb the exploitation of them by qualifying the facilitating of such exploitation as State aid.

As observed in the previous Sections, the Group may well play an important role in addressing these two challenges. If the Commission's State aid actions do not stop the use of transfer pricing mismatches, the Group should develop a common transfer-pricing policy. It should also closely monitor Member States' adequate and timely implementation of their political commitments in the area of tax ruling practices. Further, the Group could address the issue of the rate race to the bottom by strengthening the Code, specifically by extending the gateway criterion, or if necessary, requesting the Council to widen it, in order to address tax measures and practices resulting in a level of taxation below an acceptable effective level of taxation or otherwise undermining the functioning of the internal market. Such an extension could be based on the need to address the prospect of a global minimum level of corporate taxation which is currently developed in the context of the second pillar of the OECD/BEPS 2.0 project: the Global Anti-Base Erosion (GLoBE) proposal.

Such a Code-extension could lead to a wide-ranging review of Member States' laws and practices, similar to that carried out during the Group's first years of work. If the EU is serious about curbing excessive tax competition and international tax avoidance, then action needs to be taken on this issue. However, such proposals have proven very controversial so far, both within the Group and in other EU-fora, as such measures would, in fact, establish a minimum level of taxation within the EU, which has been a no-go consistently since the Ruding report (1992) suggested it. For many years, several Member States, in particular Ireland, have blocked discussions on a minimum level corporate taxation, even if the minimum rate would be lower than their current rates. These countries consider that Member States should remain in control of their national tax rates as well as of their tax bases as much as possible.

The work of the Group also paved and paves the way to a common (consolidated) corporate tax base (a C(C)CTB). The contours of such a common tax base are becoming visible through the pseudo-case law and pseudo-legislation of the Group. Remaining competitive individual tax regimes, such as patent boxes, notional interest deduction regimes, participation exemptions, etc., have been and are being coordinated according to the common pseudo-legal principles adopted by the Group for many types of regimes. Also, common tax policies are developed to address remaining general competition sensitive tax issues. Clearly, the fewer opportunities there are to compete with each other through preferential measures and practices, the less point there is in keeping twenty-eight different corporate tax systems in the air within the EU. The ongoing work of the Group, combined with the increasing (threat of the) application of the State aid prohibition to *de facto* selective national tax measures and practices and the OECD's work on BEPS, therefore, clearly increase the possibilities of a C(C)CTB to be adopted either by all Member States, or by a group of at least nine Member States under the enhanced cooperation procedure, leaving only tax *rate* competition possibilities.

Have the Code of Conduct and the Code of Conduct Group reached their goals? Yes and no: clearly, the Group has reached impressive results, and tax competition has become a much more transparent and regulated game on a much smaller and much more level playing field. But as the above also makes clear, the Group has definitely not yet succeeded in making itself redundant, and the Code still covers fiscal market distortions for which no other adequate hard law or soft law instruments of positive or negative integration are currently available, although the market distortion rules could *legally* make the Code largely redundant. The adoption of the

C(C)CTB would also make the Code obsolete. *De facto*, however, both scenarios do not seem to be politically very likely in the near future.