IS SUNLIGHT THE BEST DISINFECTANT? REASSESSING BEPS ACTION 5’S TAX RULING TRANSPARENCY

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The OECD’s BEPS Project was a major attempt to harmonize tax principles across jurisdictions and prevent tax-motivated artificial profit shifting. One portion of the BEPS Project is Action 5’s tax ruling transparency framework. High-profile instances of tax avoidance, such as LuxLeaks and the Apple/Ireland state aid case, have only elucidated the extent to which tax authorities can use rulings to facilitate tax avoidance. However, it should not be expected that Action 5’s tax ruling transparency will materially curb the use of rulings to aid tax avoidance.

For Action 5’s transparency framework to achieve its goal, it must either deter countries from issuing favorable rulings that depart from the issuing country’s tax laws and principles and other international tax norms or deter firms from utilizing these favorable rulings. This Comment argues that Action 5 does not have this deterrent effect. However, when tax ruling transparency is coupled with a disgorgement mechanism, such as in E.U. state aid law enforcement, transparency is likely to reduce the number of instances where tax rulings will serve as an effective tool to induce tax-motivated income shifting. As such, this Comment argues that a disgorgement mechanism, analogous to E.U. state aid law enforcement but with a different substantive backdrop, should be implemented to effectuate the desired behavioral responses of Action 5’s tax ruling transparency framework.

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INTRODUCTION

For decades, the taxation of cross-border income generating activities has elicited significant attention from governments and policy experts.1

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1 When this Comment was in the editing process, some countries, including the United States, began expressing their support for the proposed OECD Pillar 2 seeking to implement a “global minimum tax.” See Daniel Bunn, Designing a Global Minimum Tax with Full Expensing, TAX FOUND. (Sept. 23, 2020), https://taxfoundation.org/designing-a-global-minimum-tax-with-full-expensing [https://perma.cc/DZP6-YG8B] (providing a brief summary of the global minimum tax proposal); Jeff Stein, Yellen Pushes Global
Academics and policymakers have long been concerned about multinational enterprises (MNEs) exploiting differences in countries' tax laws to pay as little tax as possible.


First, dissenters from the global minimum tax may interfere with the efficacy of the proposal. See Rappeport, supra (explaining that some low-tax jurisdictions, such as Ireland, have not agreed to the proposal and providing a U.S. lawmaker's remarks that the proposal "would be dead on arrival in Congress"). Second, even if a global minimum tax is widely adopted, the issues analyzed in this Comment would still be prevalent. As this Comment discusses, tax rulings have been used and are likely to still be used to induce MNEs to artificially shift income to countries that issue the rulings to provide the MNEs a low effective tax rate. See infra subsection I.A.2. The global minimum tax would simply set a floor as to this effective tax rate. However, with some countries seeking to raise their corporate tax rates, the differential between the corporate rate and the global minimum tax rate could be large. Compare Johanna Hey, GibBE: Do We Need a Super-CFC?, KLUWER INT’L TAX BLOG (Nov. 4, 2020), http://kluweraxblog.com/2020/11/04/globe-do-we-need-a-super-cfc-forthcoming-intertax-vol-49-2021-issue-1 [https://perma.cc/UC8F-NC8C] (suggesting that the global minimum tax rate would be between 10% and 20%); with Garrett Watson, Huaquon Li & Taylor LaJoie; Details and Analysis of President Joe Biden’s Tax Plan, TAX FOUND. (Oct. 22, 2020), https://taxfoundation.org/joe-biden-tax-plan-2020 [https://perma.cc/SWN7-CCVZ] (explaining President Biden’s goal of raising the U.S. corporate tax rate from 21% to 28%). And this differential would incentivize countries to shift income to low-tax jurisdictions to pay the global minimum tax rather than a higher rate of tax. Accordingly, as long as countries can use tax rulings to induce income shifting, as this Comment suggests, this Comment's proposal would remain useful to counter ruling-induced income shifting.

2 See, e.g., Carol A. Brittain, Tax Evasion Through International Manipulation of Foreign Exchange Profits, 6 HASTINGS INT’L & COMPAR. L. REV. 719, 719-20 (1983) (detailing the manipulation of funds by foreign banks to evade U.S. taxes); Tracy A. Kaye, The Offshore Shell Game: U.S. Corporate Tax Avoidance Through Profit Shifting, 18 CHAP. L. REV. 185, 186 (2014) (analyzing multinational tax avoidance through manipulating intellectual property rights, debt, and transfer pricing); Edward D. Kleinbard, Stateless Income, 11 FLA. TAX REV. 700, 701-02 (2011) (explaining the ability of multinational enterprises to generate income through foreign operations while avoiding taxation by the countries where the income is derived).

3 See, e.g., JANE G. GRAVELLE, CONG. RSRCH. SERV., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 2 (2005) (noting several attempts by Congress to stem corporate tax avoidance accomplished through international income shifting); Matti Ylänen, Back from Oblivion? The Rise and Fall of the Early Initiatives Against Tax Avoidance from the 1960s and 1980s, 23 TRANSNAT’L CORPS., no. 3, 2016, at 33, 38 (discussing OECD efforts in 1956 to address international tax avoidance); Amy
little tax on income as possible. Corporate inversions and other transactions with names such as the “Double Irish With a Dutch Sandwich” have only illuminated the ease by which MNEs can shift income and either defer or completely eliminate tax liability. Countries trying to prevent this tax-motivated income shifting often seem to be playing a fruitless game of “whack-a-mole” as new tax avoidance strategies replace the old.⁴

While in many instances countries may feel slighted by taxpayers’ efforts to avoid taxation, in other instances countries intentionally facilitate opportunities for MNEs to reduce their tax liabilities.⁵ Because decreasing an MNE’s tax liability is equivalent to providing a direct cash subsidy, countries have intentionally adopted favorable tax regimes to induce firms to shift income to those countries. Countries that successfully facilitate income shifting raise a sliver of tax revenue on this income they could not otherwise obtain absent such shifting. Much of this tax competition, however, involves only artificial income shifting rather than an increase in economic activity.

And countries sometimes induce this income shifting by select taxpayers using a seemingly mundane aspect of tax administration: tax rulings. Tax rulings⁶ are a tax administration’s stance on the proper application of tax laws to a particular transaction. To obtain a ruling, the taxpayer typically submits a ruling request to the tax administration explaining the general structure of

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⁸ For the purposes of this Comment, the use of the general term “tax rulings” also includes advanced pricing agreements (APAs). For a description of APAs, see infra note 38.
the transaction at issue and how it thinks the relevant tax laws apply. The tax administration, such as the Internal Revenue Service (IRS), then responds with a ruling. Rulings may be adverse to taxpayers or beneficial to them. And rulings can go beyond merely clarifying the proper application of tax laws to a particular transaction by serving as a means to also effectively impose a taxpayer-favored tax liability, often significantly departing from the substance of the applicable tax laws.

LuxLeaks and the Apple/Ireland state aid controversy have only further highlighted countries’ use of tax rulings to induce income shifting. LuxLeaks involved a 2014 report by the International Consortium of Investigative Journalists detailing Luxembourg’s habitual practice of issuing incredibly taxpayer-favored rulings intended to remain confidential. The report details the complex financial structures involving Luxembourg subsidiaries that, by virtue of the tax rulings granted, reduced MNEs’ effective tax rates below one percent. Similarly, the Apple/Ireland state aid case showed that Apple avoided roughly €13 billion in taxes by attributing the majority of its international sales to Irish subsidiaries then, by virtue of an Irish tax ruling, allocating most of the profits to different Apple subsidiaries that were not subject to any tax.

In response to widespread artificial income shifting, such as that involved in LuxLeaks and the Apple/Ireland case, the Organization for Economic Cooperation and Development (OECD) launched its Base Erosion and

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9 See, e.g., Rev. Rul. 77-226, 1977-2 C.B. 90 (treating a share buyback and subsequent sale of the remaining shares to third parties as a single redemption to disallow a dividends received deduction and a short-term capital loss).

10 See, e.g., Rev. Rul. 74-565, 1974-2 C.B. 125 (disregarding a transitory subsidiary in a failed § 368(a)(2)(E) reorganization to allow for a tax-free reorganization under § 368(a)(1)(B) although the form of the transaction does not technically comply with the latter provision).


12 Id.

Profit Shifting (BEPS) Project. BEPS refers generally to tax avoidance strategies whereby taxpayers shift income to tax favored locations without an associated shift of economic activity, which the OECD estimates deplete countries’ tax revenues by $100-240 billion annually.14 The OECD/G20 BEPS Project,15 through its myriad policy tools called “Actions,” attempts to combat this type of tax avoidance by harmonizing tax principles across countries and creating minimum standards to which participating countries must adhere.16 While the OECD BEPS Project focuses on ending many tax avoidance strategies, Action 5 specifically addresses the issue of tax rulings by requiring all participating countries to exchange, or share, those rulings with countries whose tax bases may be affected by the tax rulings issued.17

The OECD18 and other commentators have argued that the OECD BEPS Project’s tax ruling transparency can adequately prevent countries from using rulings to grant unwarranted tax concessions.19 But others have questioned the ability of transparency to have any effect given that there are no repercussions for countries that deviate from Action 5’s tax ruling transparency minimum standards.20 These latter commentators’ conclusions

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16 Id.


19 See, e.g., Thomas Neubig, Global Tax Administration Initiatives Addressing Tax Evasion and Avoidance, 91 TAX NOTES INT’L 1337, 1440 (2018) (“[T]ransparency . . . will discourage the most egregious tax planning activity of MNEs . . . . ”); Mindy Herzfeld, News Analysis, Luxembourg Plans for a Post-BEPS World, 81 TAX NOTES INT’L 908, 908 (2016) (“[T]he automatic exchange of rulings adversely impacts jurisdictions where taxpayers depended heavily on rulings to confirm tax positions.”); Stuart Gibson, EU State Aid: More Cracks in the Wall of Secrecy, 80 TAX NOTES INT’L 473, 473 (2015) (“Combined with the final report on action 5 of the OECD’s BEPS [P]roject . . . the world seems to have built a solid foundation not only to combat base erosion and profit shifting, but also to give all tax administrations the tools to detect such abuse.”).

20 See, e.g., Allison Christians, BEPS and the New International Tax Order, 2016 BYU L. REV. 1603, 1632 (noting that there is no imposition of penalties or prohibitions for issuing preferential tax treatment through tax rulings); Itai Grinberg, The New International Tax Diplomacy, 104 GEO. L.J. 1137, 1166 (2016) (considering tax ruling transparency and noting that “[c]oordinated implementation of any kind or substantial improvements in cross-border administrative assistance . . . will prove challenging in the absence of any enforcement mechanism”); Carlo Bizi, Countering Tax Avoidance at the EU Level After “LuxLeaks”: A History of Tax Rulings, Transparency and BEPS: Base Erosion Profit Shifting or Bending European Perspective Solutions?, 7 DIRITTO E PRACTICA TRIBUTARIA
are correct.21 The OECD BEPS Project’s tax ruling transparency alone will not change firm or country behavior because exposing tax avoidance does not reduce its net benefits to either countries or firms. And participating countries do not seem to heed the OECD’s 2018 recommendation to impose sanctions on firms that improperly utilize “preferential regimes.”22 In fact, the 2018 recommendation is so fundamentally flawed that it does not warrant any serious consideration with respect to Action 5’s behavioral implications.23 Accordingly, Action 5’s tax ruling transparency will not produce the results envisioned by the OECD; namely, countries’ use of tax rulings to induce income shifting.

However, tax ruling transparency may deter some tax-motivated income shifting in the context of European Union’s state aid law.24 State aid law generally bars the use of state resources to provide a competitive advantage

[https://perma.cc/CM5-UNKZ] [hereinafter Fresh Insights] (noting that the compiled statistics are “indicative of the existence of BEPS behaviour”).

21 Their position is further substantiated by the OECD’s report in the summer of 2020 providing some empirical evidence that the BEPS Project as a whole has not had the intended effect of mitigating profit shifting. See generally OECD, CORPORATE TAX STATISTICS 44 (2d ed. 2020) (observing that OECD data suggests the existence of “BEPS channels” and the possibility of “a misalignment between the location where profits are reported and the location where economic activities occur”); see also Ryan Finley, Country Digest, OECD’S CB/C Reporting Data Show Ongoing Profit Shifting, 99 TAX NOTES INT’L 268, 268 (2020) (“Aggregated data collected by the OECD . . . suggest that the [OECD BEPS Project] hasn’t yet achieved its goal of aligning profit with value creation.”); New Corporate Tax Statistics Provide Fresh Insights into the Activities of Multinational Enterprises, OECD (Aug. 7, 2020), https://www.oecd.org/tax/new-corporate-tax-statistics-provide-fresh-insights-into-the-activities-of-multinational-enterprises.htm (noting that the compiled statistics are “indicative of the existence of BEPS behaviour”).

22 For a discussion on preferential regimes, see infra notes 102–06 and accompanying text.

23 See infra note 151.

to firms operating in E.U. Member States, and requires Member States to recover such resources that violate this standard, referred to as unlawful aid. State aid not only contemplates direct government outlays, but also the reduction of firm tax liabilities through tax rulings. As such, any tax concession that a Member State issues through a tax ruling is potentially subject to disgorgement through the enforcement of state aid law.

The OECD BEPS Project’s tax ruling transparency increases the likelihood that the Member State who issued the ruling must recover, and consequently the recipient MNE must surrender, the tax concession afforded. Increased transparency enables the European Commission—the body responsible for enforcing state aid law—to more productively identify unlawful state aid. This directly reduces the expected value of the tax concession to the recipient MNE. Consequently, rulings become less effective at inducing tax-motivated income shifting, which can change country and MNE behavior of issuing and accepting, respectively, tax concessions afforded by tax rulings. The possibility that an MNE may have to surrender the tax concession in the European Union is the sole reason to expect any behavioral changes following the implementation of Action 5’s tax ruling transparency. Action 5’s behavioral impact can only stem E.U. countries’ use of tax rulings to induce income shifting, however, because there is no comparable disgorgement or penalty mechanism for countries outside the European Union.

But even in the E.U. state aid context, tax ruling transparency will only prove moderately effective. State aid law, from a theoretical perspective, is not well equipped to handle BEPS issues, and some state aid decisions concerning tax rulings, such as the recent decision involving Apple, highlight some of its limitations. Merely extending state aid law to non-E.U. countries, while perhaps theoretically tempting because of its existing disgorgement mechanism, will not stem the use of tax rulings to facilitate tax

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26 Commission Notice on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union, 2016 O.J. 1, 36-37 [hereinafter Commission Notice on State Aid].
27 See Ruth Mason, Special Report, Tax Rulings as State Aid FAQ, 154 TAX NOTES 451, 452 (2017) (positing that tax subsidies, necessarily including those granted through tax rulings, “easily satisfy” some elements of illegal state aid and thus require the Commission to demonstrate the elements of advantage and selectivity); EUR. COMM’N, COMPETITION: STATE AID PROCEDURES (2013), https://ec.europa.eu/competition/publications/factsheets/state_aid_procedures_en.pdf [https://perma.cc/6LoM-7FPY] (explaining that when the European Commission takes a negative decision with respect to aid already paid out, the Member State must recover the aid with interest from the beneficiary).
28 See Case T-892/16, Apple Sales Int’l v. Comm’n, ECLI:EU:T:2020:338, ¶ 305 (July 15, 2020) (“[I]t must be concluded that the Commission did not succeed in showing, in the present instance, that, by issuing the contested tax rulings, the Irish tax authorities had granted ASI and AOE [two Apple subsidiaries] a selective advantage for the purposes of Article 107(1) TFEU.”).
avoidance. The state aid cases that involve tax rulings and require disgorgement of the afforded tax concession rest on flawed applications of state aid law, as they implicitly disregard the fact that the tax ruling is the sole reason the income shifting necessarily at issue occurred. As such, a BEPS-focused disgorgement mechanism, procedurally analogous to state aid law enforcement but with a substantive foundation consisting of the OECD BEPS Project Actions, other OECD guidelines, and the issuing country’s tax laws is the best means for the OECD and countries participating in the OECD BEPS Project adversely affected by tax ruling-induced income shifting to significantly combat the use of tax rulings as a tax avoidance tool.

Although some commentators acknowledge that countries are not incentivized to adhere to the OECD BEPS Project Actions, including Action 5, no work has addressed the shortcomings of tax ruling transparency using formal economic methods. More importantly, theoretical economic considerations are also absent in work mentioning the efficacy of transparency in the E.U. state aid context. As such, this Comment addresses this shortfall in the literature on tax rulings by providing a theoretical analysis of the behavioral implications of incorporating solely a transparency framework and of incorporating a transparency framework coupled with the possibility of surrendering undue tax concessions. As a result of the theoretical conclusions, this Comment proposes that the OECD form a BEPS-focused disgorgement mechanism analogous to E.U. state aid law to accompany Action 5’s transparency framework because tax ruling transparency will only trigger behavioral responses when there is a possibility that the tax concession afforded through the ruling may be subject to disgorgement.

This Comment is structured as follows. Part I provides a general overview of tax rulings, their use to facilitate BEPS strategies, and the OECD’s work to combat such uses of tax rulings. Part II then provides a theoretical analysis of expected behavioral consequences from the introduction of Action 5’s transparency framework in both the presence and absence of an existing

29 See infra notes 273–80 and accompanying text. An acknowledgement in these cases that the tax ruling was the necessary condition to induce the income shifting at issue would lead to the conclusion that the relevant Member State did not use state resources to provide a competitive advantage to the firm receiving the challenged tax concession. See Adrien Giraud & Sylvain Petit, Tax Rulings and State Aid Qualification: Should Reality Matter?, 2017 EUR. STATE AID L.Q. 233, 234 (2017) (observing that MNEs “enjoy a great deal of discretion” as to where they shift income and positing that, in the case of Ireland and Apple, “Ireland’s tax authorities negotiated Apple’s taxable basis precisely because Apple had the possibility of shifting the corresponding revenues elsewhere if a satisfying compromise was not found”); infra notes 278–80 and accompanying text.

30 All references to a “BEPS-focused disgorgement mechanism” mean a disgorgement mechanism structured to address general BEPS issues. For a detailed description of the proposed BEPS-focused disgorgement mechanism, see infra Section III.B.

31 See Neubig, supra note 19, at 1148 (“No studies have been done on the effect of transparency on government rulings, which is addressed in the harmful tax practice BEPS Action 5.”).
disgorgement mechanism. This Part concludes that desired behavioral responses to tax ruling transparency occur only when tax concessions afforded through rulings are potentially subject to disgorgement. Part III proposes a disgorgement mechanism in the context of the OECD BEPS Project. This Part analyzes the substantive and procedural aspects of E.U. state aid law and then argues that state aid law is inadequate to handle general BEPS issues. It concludes by outlining a general structure of a BEPS-focused disgorgement mechanism, with OECD BEPS Project Action items, other OECD work on tax matters, and the issuing country’s tax laws serving as the substantive backdrop.

I. TAX RULINGS, TAX COMPETITION, AND THE OECD BEPS PROJECT

Countries use tax rulings to effectively administer tax laws, and sometimes to compete for foreign investment. The OECD recognized in the 1980s that tax competition can distort economic decisions and lead to harmful tax consequences. More recently, the OECD recognized the role of tax rulings in effectuating harmful tax competition. As a result, the OECD formally addressed tax rulings as a tool for tax avoidance in the OECD BEPS Project.

A. An Overview of Tax Rulings and Their Potentially “Harmful” Uses

Tax rulings are commonplace in modern tax systems. They provide guidance on the applicable tax treatment for many, though not all, types of transactions. However, taxpayers and tax administrations also use tax rulings to provide favorable tax treatment to specific taxpayers. Some of these favorable rulings induce taxpayers to artificially shift income, which does not require a shift in economic activity but does deplete the tax bases of other countries.

1. Tax Rulings: Their Purpose and Uses

Tax rulings are pronouncements by tax authorities to taxpayers that provide guidance on how a given transaction or structure will be taxed.  


33 See, e.g., Rev. Proc. 2020-1, 2020-1 I.R.B. 18-23 (listing types of transactions where the IRS will not issue a tax ruling).

34 See OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 95 (“Rulings are ‘any advice, information or undertaking provided by a tax authority to a specific taxpayer or group of taxpayers concerning their tax situation and on which they are entitled to rely.’”) (quoting OECD, CONSOLIDATED APPLICATION NOTE: GUIDANCE IN APPLYING THE 1998 REPORT TO PREFERENTIAL TAX REGIMES ¶ 166 (2004)); see also ELLY VAN DE VEILDE, TAX RULINGS IN THE EU MEMBER STATES 6 (2015); Lilian V. Faulhaber, The Trouble with Tax Competition: From Practice to Theory, 71 TAX L. REV. 315, 333 (2018).
Generally, tax rulings fall into two broad classifications. The first type is taxpayer-specific rulings. These rulings apply to a specific taxpayer and typically entitle that taxpayer to rely on the ruling. Tax authorities can issue these rulings either before or after a transaction. Pre-transaction rulings are more common than post-transaction rulings and can further be characterized as advance tax rulings and advanced pricing agreements (APAs). In addition to taxpayer-specific rulings, the second broad classification is a general ruling. Rather than applying to a specific taxpayer, general rulings apply to groups or types of taxpayers or to a defined set of circumstances.

Tax rulings are crucial to effectively administer tax laws. Because tax laws and regulations are complex and sometimes vague, the taxpayer’s judgment may be inadequate to predict the tax consequences of a contemplated structure or transaction. Rulings provide administrative efficiency by solidifying the tax consequences of transactions or structures. This reduces the likelihood of future conflict or litigation between tax authorities and taxpayers. For instance, private letter rulings bind the relevant tax

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35 OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 97.
36 Id.
37 See id. ¶ 98 (“Typically, the taxpayer concerned will make an application for a ruling before undertaking the transaction concerned . . . .”).
38 APAs are arrangements that determine “in advance of controlled transactions, an appropriate set of criteria . . . for the determination of the transfer pricing for those transactions over a fixed period of time.” Id. ¶ 99 (quoting OECD, OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATORS § 4.123 (2010)). These rulings are more stringent than ordinary advance tax rulings in that determinations typically require verification of the factual assumptions on which the legal determinations are based. Id. ¶ 100.
39 Id. ¶ 102; see, e.g., supra notes 9–10.
40 VAN DE VELDE, supra note 34, § 1.1.2.
41 Id.; see also Biz, supra note 20, at 1938; Pierpaolo Rossi-Maccanico, Special Report, Fiscal Aid, Tax Competition, and BEPS, 75 TAX NOTES INT’L 857, 866 (2014) (“A unilateral APA . . . gives the taxpayer’s group legal certainty of the taxation of intragroup transactions . . . .”); Yehonatan Givati, Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings 29 VA. TAX REV. 137, 147 (2009) (“The advance ruling process is understood to be important for many reasons, but especially because taxpayers can achieve legal certainty regarding the tax consequences of contemplated transactions by using it.”).
42 See INT'L MONETARY FUND & OECD, Tax Certainty: IMF/OECD Report for the G20 Finance Ministers 37 (Mar. 2017) [hereinafter IMF/OECD REPORT] (noting that ruling regimes are within the set of tools identified to have the largest impact in avoiding tax disputes).
authority in many jurisdictions,\textsuperscript{44} including the IRS in the United States.\textsuperscript{45} Regardless of whether the ruling legally binds the tax authority, taxpayers can generally rely on rulings, so long as they structure their transaction in accordance with the facts in the ruling.\textsuperscript{46} As the number of tax disputes rises globally,\textsuperscript{47} many experts unsurprisingly view tax rulings as “an indispensable tool in the modern world of tax administration and compliance.”\textsuperscript{48}

While not intrinsically problematic, tax rulings may also facilitate “harmful” tax practices. Because rulings can be taxpayer-specific, they allow issuing countries to grant favorable tax treatment to individual taxpayers.\textsuperscript{49} As a result, recipients of rulings that offer favorable tax treatment shift their income to those locations. But this income shifting is not associated with a comparable increase in economic activity.\textsuperscript{50} This produces a mismatch between where income is earned and where it is taxed.

Such income shifts can also adversely impact other countries, whose taxable base is reduced as income is shifted into jurisdictions that issue favorable tax rulings.\textsuperscript{51} This tax base depletion can occur in any tax system. In

\textsuperscript{44} See Cory Hillier & Christophe Waerzeggers, Introducing an Advance Tax Ruling (ATR) Regime, TAX L. IMF TECHN. NOTE, May 2016, at 1, 1 (noting that private tax rulings typically “bind[] the tax authority in relation to the arrangement for which it is issued”); see also IMF/OECD REPORT, supra note 42, at 43 (“A private ruling is usually binding only for a particular transaction.”).

\textsuperscript{45} See Understanding IRS Guidance, supra note 43 (“A [private letter ruling] is binding on the IRS if the taxpayer fully and accurately described the proposed transaction in the request and carries out the transaction as described.”)

\textsuperscript{46} OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 98.


\textsuperscript{48} Biz, supra note 20, at 1038 (quoting Maarten J. Ellis, General Report, 8th CAHIERS DE DROIT FISCAL INTERNATIONAL 21, 24 (1999)).

\textsuperscript{49} See Grinberg, supra note 20, at 1164 (noting that the purpose of the OECD BEPS Project Action 5’s spontaneous exchange of tax rulings is to “cabin special tax deals” between foreign MNEs and countries); Nina Hrushko, Note, Tax in the World of Antitrust Enforcement: European Commission’s State Aid Investigations into EU Member States’ Tax Rulings, 43 BROOK. J. INT’L L. 327, 338 (2017) (explaining that tax rulings can constitute illegal state aid, which necessarily requires a selective advantage).

\textsuperscript{50} Jeffrey Owens, The David H. Tillinghast Lecture—Tax Competition: To Welcome or Not, 65 TAX L. REV. 173, 180 (2012) (distinguishing between investment and taxable profits and explaining methods to reduce taxable income in jurisdictions where the income is earned); see also OECD, 1998 REPORT, supra note 7, at 30 (noting that the “[i]nappropriate use of advanced rulings and . . . individual negotiated agreements can . . . distort the competitive position of countries”).

\textsuperscript{51} See supra note 7; see also Samuel Johnston, Multilateral Tax Convention to Prevent Base Erosion and Profit Shifting, 23 AUCKLAND U. L. REV. 384, 384 (2017) (“This issue is referred to as base erosion and profit shifting (BEPS)—the tax bases of high tax jurisdictions are eroded and profits are shifted to low or no tax jurisdictions.”); Kerrie Sadiq, Adrian Sawyer & Bronwyn McCredie, Jurisdictional Responses to Base Erosion and Profit Shifting: A Study of 19 Key Domestic Tax Systems, 16 JOURNAL TAX RSCH. 737, 752 (2019) (noting that resident entities can “strip the tax base” of their resident country by holding an interest in a foreign firm).
“worldwide” tax systems, residents are taxed on their global earnings.52 Residence country tax bases decrease because MNEs can operate through foreign entities to both utilize favorable rulings and defer immediate residence-country taxation by avoiding provisions that attribute foreign subsidiary earnings to the resident MNE. In systems more akin to “territorial” tax systems that generally exempt foreign source income from tax,53 residence-country tax base depletion occurs because MNEs can operate through foreign entities that derive income that is generally exempt from residence-country tax while also avoiding the tax system’s provisions that are more akin to those in a worldwide system, with rulings incentivizing MNEs to shift income so that it is not sourced to the resident country. Therefore, the favorable tax treatment provided by rulings can induce income shifting to the detriment of other countries’ tax bases.

While potentially harmful to residence countries’ tax bases, these income shifting strategies are desirable from an MNE’s perspective. Shifting income to a low-tax jurisdiction and avoiding residence country taxation effectively allows the MNE to achieve “double non-taxation,” or negligible tax liability that is due immediately to the residence country and to the country to which the MNE shifted its income.54 Although income shifting does not require tax rulings,55 tax rulings exacerbate the phenomenon by effectively allowing for individualized tax liabilities56 and creating opportunities for tax avoidance that were either nonexistent or not as attractive without a tax ruling.


53 Id. at 3. A “pure” territorial system entirely exempts foreign source income from residence country tax. See id. at 2. Most OECD countries have hybrid systems with aspects of both worldwide and territorial systems. Id.

54 OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING 15 (2013) [hereinafter OECD, BEPS ACTION PLAN] (observing that the interaction of different countries’ tax rules can reduce or eliminate tax liability); see also Christian Kahlenberg, Prevention of Double Non-taxation: An Analysis of Cross-Border Financing from a German Perspective, 43 INTER TAX 218, 218 (2015) (recognizing MNEs’ tax planning strategies to shift income to “tax havens,” which leads to double non-taxation); Base Erosion and Profit Shifting (“BEPS”), PWC (Sept. 25, 2019), https://perma.cc/FY9W-VCEL (explaining that base erosion and profit schemes often lead to double non-taxation).

55 See What Is BEPS, supra note 14 (noting that income shifting can result from discrepancies between different countries’ tax laws).

2. Tax Rulings and Tax Competition: An Analysis of the Apple/Ireland State Aid Case

The previous subsection detailed the general types of tax rulings and how they can be used to effectuate tax avoidance. The Apple/Ireland state aid case illustrates the operation of rulings, the types of transactions and structures involved, the means for MNEs to artificially shift income, and the ability of rulings to immediately reduce tax liability.

Apple Inc. is a U.S.-based technology company that primarily sells consumer technology goods. Since 1980, Apple Inc. has organized its sales by allocating them between two separate regions. The U.S.-based Apple Inc. handles sales in the Americas while Apple Sales International coordinates Apple's sales efforts in Europe, the Middle East, Africa, India, Asia, and the Pacific. Apple Sales International is an Irish-incorporated entity and a direct subsidiary of Apple Operations Europe. Apple Operations Europe is the Irish subsidiary of Apple Operations International, which is an Irish incorporated entity ultimately owned by Apple Inc. Apple Operations Europe is primarily responsible for manufacturing certain lines of Apple products. Although Apple Sales International and Apple Operations Europe are both Irish-incorporated entities ultimately owned by U.S.-based Apple Inc., they are both stateless for tax purposes as they are neither tax residents of Ireland or the U.S. Because countries generally only have the right to tax entities with tax residency in that country, neither Ireland nor the U.S. could tax Apple Sales International and Apple Operations Europe.


59 Id. at ¶ 47 & fig.t.

60 Id.


62 See Commission Decision 2017/1283, supra note 13, at 7 ¶ 52 (“During the time that the contested tax rulings were in force, ASI and AOE could therefore be best described as ‘stateless’ for tax residency purposes”); see also Levin & McCain, supra note 57, at 23-24 (noting that these entities do not have any tax residency because they do not meet Ireland’s “management and control” test of residency or the “place of formation” residency requirement of the United States).

63 A country can tax income of nonresidents if the source of the nonresident’s income is that country. For example, the United States taxes foreign entities on items of income if the source of that income is the U.S. E.g., I.R.C. §§ 861-65, 882, 884, 1442 (providing for U.S. taxation of foreign corporations for U.S. source items of income).
The E.U. state aid case initiated by the European Commission involved tax rulings that Ireland issued in 1991 and 2007 to both Apple Sales International and Apple Operations Europe. The rulings authorized both entities to internally allocate their income between themselves and their respective Irish branch offices. The 1991 ruling to Apple Operations Europe provided that the net profit attributable to its branch office would be the sum of 65% of Apple Operation Europe’s operating expenses up to $60-70 million and 20% of such expenses in excess of $60-70 million. The 2007 ruling revised the profit determination for the branch office to be a 10-15% margin on Apple Operation Europe’s operating costs, excluding certain costs, plus a fixed 1-5% return on its intellectual property. The 1991 ruling to Apple Sales International provided that net profit attributable to its branch office for tax purposes would be 12.5% of Apple Sales International’s operating costs, excluding certain costs. The 2007 ruling changed the percentage from 12.5% to 10-15%. Apple Operations Europe and Apple Sales International allocated their remaining earnings to their respective “head offices,” which were non-Irish residents for tax purposes.

The rulings that Ireland issued to Apple Sales International and Apple Operations Europe significantly decreased each entity’s respective tax liabilities. Each year in which the rulings applied, Ireland only taxed the profits allocated to the branch offices of Apple Sales International and Apple Operations Europe. However, the branch office profits were significantly less than profits allocated to the head offices. For example, in 2011 Apple Sales International recorded total profits of roughly €16 billion, but because of the ruling, Ireland taxed approximately €50 million. As a result, the effective tax rate on Apple Sales International’s profits was consistently below Ireland’s statutory tax rate of 12.5% and from 2011 to 2014, for example, ranged from 0.05% in 2011 to 0.005% in 2014.

65 Id.
66 At the time Apple Operations Europe was Apple Computer Ltd. Id. at ¶ 61.
67 Id. at ¶ 61.
68 Id. at 10 ¶ 62.
69 At the time Apple Sales International was Apple Computer Accessories Ltd. Id. at ¶ 59.
70 Id.
71 Id. at ¶ 60.
72 Press Release, Eur. Comm’n, supra note 13, at 1 (“These profits allocated to the ‘head offices’ were not subject to tax in any country under specific provisions of the Irish tax law, which are no longer in force.”).
75 See id.
But why would Apple want to decrease its Irish tax liability? The U.S.-based Apple ultimately owns the Irish entities, and U.S. residents are subject to tax on their worldwide income. As a result, one may suspect that Apple would owe U.S. tax on the Irish earnings of its subsidiaries, less a credit for Irish taxes paid.76 And because the Irish tax liability was relatively small, the U.S. tax would be relatively large. However, as mentioned, U.S. based MNEs can avoid U.S. income tax liability on profits earned outside the U.S., which is precisely what Apple did. In effect, these rulings afforded Apple a relatively low current Irish tax liability while it deferred its U.S. tax liability by shifting income to its Irish subsidiaries.

Because tax rulings set Apple’s Irish tax so low, Apple shifted its income to both utilize the favorable effective rate afforded by the rulings and to circumvent the Internal Revenue Code (Code).77 This income-shifting structure enabled Apple to defer U.S. income tax liability on its Irish subsidiaries’ earnings. A detailed explanation of this structure is helpful to fully appreciate the utility and mechanics of international income shifting for Apple, and U.S.-based MNEs in general, and tax rulings’ role in this shifting.

Although U.S. residents are subject to U.S. income tax on their worldwide incomes, foreign subsidiaries are respected by the Code as entities that are separate from their U.S. parent companies. As such, foreign subsidiary income is generally not taxable until there is a “recognition event,”79 such as

76 See I.R.C. § 61(a) (“Gross income means all income from whatever source derived . . . .”); Treas. Reg. § 1.1-1(b) (as amended in 2008) (“[A]ll citizens of the United States . . . are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States.”); see also Joseph B. Darby III & Kelsey Lemaster, Double Irish More than Doubles the Tax Savings, PRAC. US/INT’L TAX STRATEGIES, May 15, 2007, at 2, 2 (noting that domestic corporations are subject to U.S. income tax on their worldwide income).

77 See I.R.C. § 901(a), (b)(1) (providing a credit for income taxes paid to a foreign country during the taxable year); see also Tax Convention, Ir.-U.S., art. 29(2)(a), July 28, 1997, S. TREATY DOC. No. 105-31 (1997) (“This Convention shall enter into force . . . in respect of taxes withheld at source, for amounts paid or credited . . . .”).

78 The following description of Apple’s tax avoidance involving the Irish tax rulings occurred before the Tax Cuts and Jobs Act (TCJA), when the Code was more akin to a worldwide system of taxation. Apple’s strategy was to avoid tax imposed under Subpart F of the Code, which it successfully did utilizing the “check-the-box” regulations. See infra notes 82–95 and accompanying text. However, even with the Code’s shift towards a more territorial system, the TCJA did not materially alter either Subpart F or the check-the-box regulations, although the § 245A deduction for the foreign portion of foreign corporation dividends reduced the importance of the check-the-box regulations as they pertain to the passive income portion of Subpart F, including items of income used to compute § 954(a)(1) foreign personal holding company income. J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, Expanded Worldwide Versus Territorial Taxation After the TCJA, 161 TAX NOTES 1173, 1179, 1181 (2018). As a result, the TCJA may not have completely undermined the efficacy of Apple’s tax avoidance strategy.

79 Darby & Lemaster, supra note 76, at 14.
sales or exchanges of assets. In the context of cross-border organizational structures and transactions, recognition events are typically dividend distributions from a non-U.S. subsidiary to the U.S. parent or the sale of the non-U.S. subsidiary.

Subpart F of the Code, however, is an exception to this general tax principle and attempts to tax currently U.S. parent corporations on specific types of income earned by their foreign subsidiaries. Subpart F imposes tax on “United States shareholder[s]” for income earned by “controlled foreign corporation[s]” (CFCs). A foreign corporation is a CFC if U.S. shareholders own more than fifty percent of either the foreign corporation’s voting power or the total value of its stock. A U.S. shareholder is defined as a “United States person” owning at least ten percent of the voting power or share value of a foreign corporation. U.S. shareholders are subject to tax on their pro rata share of a CFC’s “Subpart F income” which includes, among other categories, “foreign base company sales income” and “foreign personal holding company income,” both of which are subsets of § 952(a)(2) “foreign base company income.” Foreign base company sales income includes income derived from the sale of property sold to or initially purchased from a related person or sold or purchased on behalf of a related person, where the property was neither produced nor consumed in the CFC’s country of organization.

At first glance, it seems like Subpart F dictates that U.S.-based Apple Inc. must pay taxes on the income earned by Apple Operations Europe and Apple

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80 See I.R.C. § 61(a)(3) (including in gross income gains derived from property dealings); id. § 1001(a) (providing the method for computing the "gain from the sale or other disposition of property" (emphasis added)); id. § 1001(c) (requiring the recognition of gain from the sale or exchange of property).
81 See Fleming Jr. et al., supra note 78, at 1174.
83 Darby & Lemaster, supra note 76, at 2.
84 I.R.C. § 951(a)(1). For brevity’s sake, I use the term “U.S. shareholders” as a substitute for “United States shareholder[s]” in this Section. See id.
85 Id. § 957(a).
86 Id. § 951(b). U.S. persons include U.S. based corporations. See id. (cross-referencing id. §§ 957(c), 7701(a)(30)(C)). Ownership in the foreign corporation can be direct ownership, indirect ownership, or constructive ownership as determined by applying the attribution rules provided in § 318(a) subject to some modifications. See id. §§ 951(b), 958(a)-(b); Treas. Reg. § 1.958-2(a), (c)-(d) (as amended in 2020).
87 I.R.C. § 951(a)(1)(A); see also Treas. Reg. § 1.951-1(e) (as amended in 2019) (detailing the computation of a U.S. shareholder’s pro rata share of subpart F income).
88 I.R.C. § 952(a)(2) (cross-referencing id. § 954(a)(1)-(2)).
89 Id. § 954(d)(1).
90 See id. § 954(c)(1) (including dividends, interest, royalties, rents, annuities, commodities gains and losses, and foreign currency gains and losses, among other items, within the definition of foreign personal holding company income).
Sales International. Apple Sales International’s and Apple Operations Europe’s sales appear to be foreign base company sales income, and any distributions from Apple Sales International to Apple Operations Europe or Apple Operations Europe to Apple Operations International appear to be foreign personal holding company income.

Apple, however, avoided Subpart F and thus deferred U.S. tax on income generated by its foreign subsidiaries by using other parts of the Code and Treasury regulations. Apple primarily relied upon the “check-the-box” regulations, which allow a parent company’s wholly owned foreign subsidiary to be disregarded for tax purposes upon the subsidiary’s election to be treated as such. ¹⁻¹¹ Apple’s election under these regulations rendered all its foreign subsidiaries, other than Apple Operations International, “disregarded entities.” Apple Sales International, Apple Operations Europe, and other foreign subsidiaries were all treated as part of Apple Operations International for tax purposes, and those subsidiaries’ transactions were treated as Apple Operations International’s transactions. ¹⁻¹²

As such, Apple had no foreign base company income. Although distributions between these entities would ordinarily constitute foreign personal holding company income under Subpart F, the distributions were not attributable back to Apple Inc. because they were treated as occurring exclusively within Apple Operations International and not between different corporate entities.

By treating all subsidiaries as part of Apple Operations International, income from inter-subsidiary sales of Apple products was not foreign base company sales income. Because the subsidiaries were disregarded, “it [was] as if no intercompany sales happened at all.” ¹⁻⁻³ To distribute physical product to foreign markets, Apple Sales International purchased finished product from a third-party manufacturer, then resold the product to offshore distribution subsidiaries. These distribution subsidiaries then sold the product to end users. ¹⁻⁻⁴ In form, the final sales to customers should have generated foreign base company sales income because they were “derived in connection with the purchase of personal property from a related person;” namely, the distribution subsidiaries’ purchases from Apple Sales

¹⁻¹¹ See Treas. Reg. § 301.7701-2(a) (as amended in 2019); Treas. Reg. § 301.7701-3(a), (b)(2) (as amended in 2020) (allowing a wholly owned foreign subsidiary properly characterized as a “[f]oreign eligible entity” to elect to be disregarded and treated as a division of its parent company); Levin & McCain, supra note 57, at 35-36 (describing how Apple avoiding paying Subpart F income tax by electing to disregard its wholly owned subsidiaries through the check-the-box regulations); see also Darby & Lemaster, supra note 76, at 12.

¹⁻¹² See Treas. Reg. § 301.7701-2(a) (“[I]f the entity is disregarded, its activities are treated in the same manner as a . . . division of the owner.”).

¹⁻⁻³ Levin & McCain, supra note 57, at 36.

¹⁻⁻⁴ Id. at 32 & fig.
International.\textsuperscript{95} However, because the check-the-box regulations rendered all subsidiaries besides Apple Operations International disregarded, Apple Operations International was effectively treated as the sole entity that purchased the product from a third-party manufacturer and made the sales to end consumers.

Apple’s ability to circumvent Subpart F and thus defer U.S. tax elucidates the attractiveness of Ireland’s tax rulings issued to Apple. Apple secured a relatively low effective Irish tax rate on its subsidiaries’ earnings while structuring its operations to avoid tax on those subsidiaries’ Subpart F income. The use of the Code and accompanying Treasury regulations to avoid U.S. tax is not unique to Apple, nor is a tax ruling a necessary condition to avoiding U.S. tax liability. However, tax rulings, because of their potential to effectively reduce MNE tax liability in the issuing country below what the applicable tax laws seemingly mandate, can create more instances of and render more attractive tax-motivated income shifting.

B. The OECD’s Earlier Work on Harmful Tax Practices

The OECD has long noticed the ability of MNEs to shift income to low-tax jurisdictions. It has also noticed the role of countries in encouraging this income shifting. The OECD’s first major attempt to address income shifting and tax competition was its report entitled \textit{Harmful Tax Competition} (1998 Report). The 1998 Report became the motivation and foundation of the OECD BEPS Project and tax ruling transparency.

\footnotesize{\begin{quote}
\textsuperscript{95} I.R.C. § 954(d)(1). Importantly, neither of the major exceptions to foreign base company sales income provided implicitly by the Code and explicitly by the Treasury regulations under § 954 were applicable. Because the products sold were manufactured in China, the exceptions for property manufactured in the CFC’s country of incorporation and for property manufactured by the CFC, known as the manufacturing exceptions, were inapplicable. See \textit{id.} § 954(d)(1)(A) (defining foreign base company sales income as income from sales of personal property “manufactured, produced, grown, or extracted outside the country under the laws of which the [CFC] is created or organized” (emphasis added)); Treas. Reg. § 1.954-3(a)(1)(i), (2), (4)(iii) (clarifying that the property sold must be manufactured outside the CFC’s country of organization to yield foreign base company sales income). Also, because the transactions were between Apple Sales International and the distribution subsidiaries, the exception for property consumed within the selling company’s country of incorporation was inapplicable. See I.R.C. § 954(d)(4)(B) (defining foreign base company sales income as income from sales of personal property “sold for use, consumption or disposition outside” the CFC’s country of organization (emphasis added)); Treas. Reg. § 1.954-3(a)(3). Accordingly, the use of the check-the-box regulations was crucial for Apple to avoid tax under Subpart F.
\end{quote}}
1. The 1998 Report

The OECD began its work to combat income shifting by influencing national tax policies in the 1980s. At that time, taxpayers began using sophisticated international structures to exploit discrepancies among national tax laws, which agitated countries and frustrated their fundamental task of raising revenue. During this time, but before issuing the 1998 Report, the OECD offered some remedies to alleviate tax avoidance, such as model transfer pricing guidelines and bilateral tax conventions. In 1994, the OECD began approaching tax competition more directly, ultimately producing the 1998 Report.

The 1998 Report accomplishes two primary functions of “identifying harmful tax regimes and labeling tax havens.” The 1998 Report begins with the observation that countries use tax policies to attract financial and other mobile income from MNEs and individuals. The portion of the Report dedicated to harmful preferential tax regimes aims to identify tax policy that facilitates this sort of income diversion.

The 1998 Report proffered several primary factors for the OECD and countries to determine whether a tax regime is harmful and preferential. First, a regime would need to apply a low or zero effective tax rate on geographically mobile income.

Geographically mobile income is income generated by activities “which can be most easily shifted in response to tax

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96 See Morriss & Moberg, supra note 32, at 33 (noting that the OECD began influencing tax policy in the 1980s to protect against tax competition that arose from taxpayers’ ability to shift income geographically).
97 See id. at 33-39 (describing the evolution of “tax havens” in places like the Cayman Islands, and the resulting revenue losses to national tax collectors, as well as the tax-planning competition among large, developed economies).
99 See Morriss & Moberg, supra note 32, at 39-40, 42-43 (describing the failure of the OECD’s first effort to combat tax competition, the “Project on Fiscal Degradation” (launched in 1994), and the ultimate success of the 1998 Report).
100 Faulhaber, supra note 34, at 327.
101 OECD, 1998 REPORT, supra note 7, ¶ 23.
102 See id. ¶ 57 (“Many OECD Member and non-member countries have already established or are considering establishing preferential tax regimes to attract highly mobile financial and other service activities. . . . This section discusses factors that may help identify harmful preferential tax regimes, without targeting specific countries.”).
103 Id. at 25-27; see also Faulhaber, supra note 34, at 329 (noting that the OECD considered tax regimes harmful when they “offered rates that were lower than the overall corporate rate in the jurisdiction”).
differentials,” such as financial and other service activities.\textsuperscript{104} To qualify as harmful and preferential, a regime would then need to either (1) be “ring-fenced,” or one in which domestic taxpayers typically could not benefit from the regime; (2) operate with little transparency; or (3) not be subject to information sharing with other countries regarding the regime.\textsuperscript{105}

The 1998 Report concludes with recommended measures to combat harmful preferential regimes. It instructed OECD member countries to review their preferential regimes to determine whether they are harmful, and if found to be harmful, abolish the regimes or the regimes’ harmful aspects.\textsuperscript{106}

The Report also authorized countries to enact or strengthen defensive measures against harmful preferential regimes existing elsewhere, such as implementing or strengthening CFC rules\textsuperscript{107} similar to the U.S. Code’s Subpart F described above.\textsuperscript{108} In addition to the prescribed defensive measures, the OECD also created the Forum on Harmful Tax Practices (FHTP) to assist member countries in assessing and reviewing their preferential regimes.\textsuperscript{109}

\textbf{C. The OECD BEPS Project and Tax Ruling Transparency}

The OECD’s work on harmful tax practices and income shifting did not end with the 1998 Report. In 2012, G-20 countries requested that the OECD develop a plan to address BEPS by MNEs.\textsuperscript{110} The OECD subsequently produced an action plan, which highlighted the impact of BEPS on countries’ tax bases and proffered broad measures to tackle BEPS.\textsuperscript{111} This action plan ultimately culminated in the introduction of the OECD BEPS Project in 2015.\textsuperscript{112}

\textsuperscript{104} OECD, 1998 REPORT, supra note 7, ¶ 57-58. Importantly, the 1998 Report explicitly excludes from its scope the use of tax incentives to attract investments in plants, building, and equipment. Id. ¶ 6.

\textsuperscript{105} Id. at 27; see also Faulhaber, supra note 34, at 329. The Report provided other factors that can help with the determination as to whether a country’s tax regime is harmful and preferential, including the economic effects of the regime. OECD, 1998 REPORT, supra note 7, ¶¶ 68-84; see also Faulhaber, supra note 34, at 328 n.88.

\textsuperscript{106} OECD, 1998 REPORT, supra note 7, at 56-57; see also Morriss & Moberg, supra note 32, at 45.

\textsuperscript{107} OCED, 1998 REPORT, supra note 7, ¶¶ 86-87 (recommending unilateral defensive measures in addition to multilateral responses); see also id. ¶¶ 97-137 (providing examples of unilateral, bilateral, and multilateral defensive measures to combat harmful preferential tax regimes).

\textsuperscript{108} See supra notes 82–90 and accompanying text.

\textsuperscript{109} OECD, 1998 REPORT, supra note 7, annex I at 65-66; see also Faulhaber, supra note 34, at 328.

\textsuperscript{110} OECD, BEPS ACTION PLAN, supra note 54, at 11.

\textsuperscript{111} See id. at 7-26 (providing background on the problems posed by BEPS and laying out fifteen action items to counter BEPS).

\textsuperscript{112} OECD, BACKGROUND BRIEF: INCLUSIVE FRAMEWORK ON BEPS 7 (2017).
The OECD BEPS Project’s Actions

The OECD BEPS Project is founded on three pillars: “coherence, substance, and transparency.”113 To this end, the “BEPS Package” consists of “soft law” tools,114 consistent with the foundational pillars, to help countries combat tax avoidance by MNEs.115 The aim of these tools is to ensure that profits are taxed “where economic activities generating the profits are performed and where value is created.”116 Essentially, the BEPS Package attempts to align the location of taxation and economic activity to stem artificial income shifting that serves no economic purpose. The OECD BEPS Project’s emphasis on coherence and transparency in international tax matters aid in this alignment.

To effectuate these goals, the OECD BEPS Project recommends fifteen “Actions.”117 Generally, these Actions can be divided between “minimum standards” and other broad implementations, such as best practices.118 The minimum standards are policies that “[c]ountries and jurisdictions of relevance” must implement to achieve a “level playing field.”119 The broader implementations strive to reinforce desirable international tax standards and provide for best practices that participating countries should follow.120

The Actions, which correspond to the aforementioned pillars, address more specific phenomena that facilitate tax avoidance. Action 1 deals with tax challenges unique to the current digital economy.121 Actions 2, 3, and 4 attempt to instill coherence in international standards on matters such as CFC rules and interest deductibility.122 Actions 5 (in part)123 and 6 through 10 help to ensure that substance governs taxation, rather than purely tax-motivated structures.124 Actions 5 (in part)125 and 11 through 14 aim to enhance transparency in areas such as transfer pricing documentation and tax

113 Biz, supra note 20, at 1055.
114 OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: 2015 FINAL REPORTS FREQUENTLY ASKED QUESTIONS 5 (2015); see also Christians, supra note 20, at 1644-45 (describing the features of the BEPS Package as “common forms of soft law governance”).
116 Id.
117 Id.
118 See OECD, 2018–2019 PROGRESS REPORT, supra note 18, at 16, 21 (contrasting the “minimum standard” of Action 14 with the “best practice[]” recommendations of Actions 2, 3, and 4).
120 See OECD, 2018–2019 PROGRESS REPORT, supra note 18, at 2.
121 Biz, supra note 20, at 1055.
123 The portion of Action 5 that concerns substance is the work on preferential tax regimes. Id. at 2-3.
124 OECD, 2019–2020 PROGRESS REPORT, supra note 18, at 1, 18-20.
125 The portion of Action 5 that concerns transparency is the exchange of information on tax rulings. OECD, 2018–2019 PROGRESS REPORT, supra note 18, at 3.
ruling practices. Finally, Action 15 addresses the need to quickly implement the OECD BEPS Project’s Actions.

2. Action 5’s Transparency Framework

Action 5 of the OECD BEPS Project, in part, mandates tax ruling transparency. More specifically, Action 5 calls for the “compulsory spontaneous exchange of information in respect of [tax] rulings,” which historically were confidential and not shared with other jurisdictions. The transparency framework applies to only some rulings. First, Action 5 covers only taxpayer-specific rulings as opposed to general rulings. General rulings are only contemplated by the transparency framework’s “best practices.” Second, the rulings must be such that the absence of transparency would give rise to “BEPS concerns.” Action 5 explicitly contemplates the following rulings as potentially giving rise to BEPS concerns: (1) rulings pertaining to preferential regimes, (2) unilateral APAs or other cross-border rulings pertaining to transfer pricing, (3) cross-border rulings providing a downward adjustment to taxable profits, (4) permanent establishment (PE) rulings,

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126 Id. at 9, 14, annex B at 31-32.
127 Biz, supra note 20, at 1055.
128 The remainder of Action 5 concerns preferential regimes, a continuation of the OECD’s earlier work on the 1998 Report. See OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 1-2, 23.
129 Id. ¶¶ 91-94; see also OECD, TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING: ACTION 13 – 2015 FINAL REPORT ¶ 15; id. annex I to ch. V at 26; id. annex II to ch. V, at 28 (2015) [hereinafter OECD, ACTION 13 – 2015 FINAL REPORT] (requiring MNEs to document and share certain transfer pricing information, including tax rulings and APAs).
130 Stuart Gibson, EU State Aid: More Cracks in the Wall of Secrecy, 80 TAX NOTES INT’L 473, 473 (2015) (describing tax ruling practices in countries such as the Netherlands and U.S. and noting that these countries keep rulings “secret” and do not exchange them with other countries).
132 OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 102.
133 Id. ¶ 91; see also Faulhaber, supra note 34, at 338 (“[R]ulings that could ‘give[] rise to BEPS concerns,’ . . . include five enumerated categories of rulings and can only include other types of rulings if all countries in the FHTP agree.” (quoting OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 120)).
134 When an enterprise conducts business operations in a foreign country, the enterprise is generally subject to that country’s tax laws. However, if the enterprise’s residence country and the foreign country have a tax treaty, that treaty will, as is typical, provide for a minimum level of activity an enterprise must conduct to be subject to tax by the foreign country. This minimum level of activity is PE. What Is a Permanent Establishment?, BAKER TILLY US, LLP (Jan. 7, 2019), https://www.bakertilly.com/insights/what-is-a-permanent-establishment [https://perma.cc/VDR4-GYW4]; see also OECD, PREVENTING THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT STATUS: ACTION 7 – 2015 FINAL REPORT 9 (2015) [hereinafter OECD, ACTION 7 – 2015 FINAL REPORT] (“[T]he business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has in that State a permanent establishment (PE) to which the
(5) related party conduit rulings, and (6) any other type of ruling that the FHTP agrees would give rise to BEPS concerns in the absence of a spontaneous exchange of information.\textsuperscript{135} Third, the rulings must be either “future” or “past” rulings.\textsuperscript{136} Future rulings include those issued on or after April 1, 2016.\textsuperscript{137} Past rulings are those issued after January 1, 2010 and still in effect as of January 1, 2014.\textsuperscript{138}

Action 5 also indicates with whom the issuing country must exchange applicable rulings. In general, the issuing country “must automatically exchange” the ruling with countries that the ruling may affect,\textsuperscript{139} which includes the countries of residence of the immediate and ultimate parent companies of the taxpayer and the countries of residence of all related parties\textsuperscript{140} incident to the ruling.\textsuperscript{141} PE rulings also require an exchange with the residence country of the head office or the country of the PE, as the case may be, while related party conduit rulings require an additional exchange with the country of residence of the “ultimate beneficial owner . . . of payments made to the conduit.”\textsuperscript{142}

The OECD also prescribed practical implementation measures and best practices for the automatic exchange of information pertaining to tax rulings. For example, issuing countries should exchange future rulings as soon as possible but no later than three months after issuing the ruling, and recipient countries should ensure that taxpayer information contained in the ruling remains confidential.\textsuperscript{143} The best practices contemplate the process of granting

\begin{itemize}
  \item profits are attributable.”).
  \item As such, a PE ruling can effectively determine whether an enterprise is subject to tax in a foreign country in which it operates.
  \item The requisite level of activity can differ across treaties. The U.S.-Ireland tax treaty, for example, defines PE as “a fixed place of business through which the business of an enterprise is wholly or partly carried on” yet excludes, for example, storage facilities. Tax Convention, supra note 77, art. 5(1).
  \item OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 91; see also Christians, supra note 20, at 1672 (discussing the ways in which the OECD is developing the exchange of administrative rulings); Achim Pross, Kevin Shoom & Melissa Dejong, Harmful Tax Incentives Critically Curtailed: BEPS Action 5 in Action, INT’L TAX. REV., Nov. 2017, at 14, 14 (discussing the work on preferential tax regimes under BEPS Action 5).
  \item OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 126 (emphasis omitted). There is no obligation to exchange past rulings if on or after September 1, 2017 the country either joined the Inclusive Framework or was identified as a “jurisdiction of relevance.” OECD, BEPS ACTION 5 ON HARMFUL TAX PRACTICES – TRANSPARENCY FRAMEWORK 10 (2021).
  \item OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 129.
  \item Id. ¶ 126; see also Mindy Herzfeld, News Analysis, Looking Forward to 2016, 80 TAX NOTES INT’L 985, 986 (2015).
  \item Faulhaber, supra note 34, at 333.
  \item Two parties are related if one has at least a 25% investment in the other or a third party has at least a 25% investment in the two parties. OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 122.
  \item See id. ¶ 121.
  \item Id. ¶ 124.
  \item Id. ¶¶ 133-40.
\end{itemize}
a ruling, the time period of the ruling’s effect, and the publication of rulings.\footnote{\textit{Id.} ¶ 141.} Moreover, the exchanged information should include a summary of the transaction at issue as well as an indication of the recipient entity’s profit.\footnote{\textit{Id.} annex C at 78-79.}

Since the promulgation of Action 5’s transparency framework, participating countries have actively exchanged tax rulings. The OECD reviews participating countries’ exchange practices annually\footnote{\textit{See Grinberg, supra note 20, at 1165.}} and issues Progress Reports detailing the amount of exchange and the level of compliance.\footnote{\textit{Action 5: Harmful Tax Practices, OECD, https://www.oecd.org/tax/beps/beps-actions/actions5/#::text=The%20Forum%20on%20Harmful%20Tax,\text{https://perma.cc/3MJ9-Nq2D}} (stating that the FHTP will conduct the peer review and monitoring process with respect to Action 5’s transparency framework).\footnote{\textit{Id.}}

As of July 2020, countries participating in the OECD BEPS Project exchanged approximately 18,000 rulings.\footnote{OECD, 2019–2020 \textit{PROGRESS REPORT}, supra note 18, at 16.} Currently, OECD review indicates that 80 out of 112 jurisdictions did not receive any recommendations regarding their exchange practices pursuant to Action 5.\footnote{\textit{Id.}} However, during review, the OECD made 55 recommendations to 32 jurisdictions, indicating that some jurisdictions are not fully complying with Action 5’s framework.\footnote{\textit{See id.}}

But what happens when a country fails to comply with Action 5’s exchange requirement? And of greater concern: what happens when a country issues a ruling, but the ruling’s subject matter deviates from a normal application of the country’s tax laws, regardless of whether the country exchanges the ruling or not? And what happens when this ruling deviates from an OECD BEPS Project Action or other OECD guidance? This Comment addresses what enforcement measures the OECD BEPS Project contemplates for these violative tax rulings.

The OECD BEPS Project does not contemplate direct repercussions for violative tax rulings. In 2018, the OECD recommended that countries impose penalties on MNEs that fail to satisfy the substantial activities requirement with respect to preferential regimes addressed in Action 5. But it does not seem that any countries have instituted this recommendation, and the suggestion is fundamentally flawed because it places the responsibility of penalizing MNEs on the country instituting the harmful preferential regime in the first place, seemingly ignoring that these regimes are designed to induce artificial income shifting.\footnote{In 2018, the OECD issued a report (2018 Report) concerning the substantial activities requirement of Action 5’s guidance with respect to harmful preferential regimes. OECD, \textit{Resumption of Application of Substantial Activities Factor to No or Only Nominal Tax Jurisdictions} ¶¶ 21-23 (2018). To ensure compliance with the substantial activities requirement, the OECD recommends that a jurisdiction that has the preferential regime
on an issuing country if the ruling’s subject matter violates an OECD BEPS Project Action, other OECD guidance, or a normal application of the issuing country’s tax laws.\textsuperscript{152} Only limited defensive measures,\textsuperscript{153} designed to mitigate the adverse tax consequences of the ruling to the MNE’s residence country, are available when a violative ruling adversely impacts another country.\textsuperscript{154} For example, if a ruling pertains to a preferential regime later found to be harmful under Action 5 and the issuing country fails to abolish the harmful preferential regime, affected countries may only take authorized defensive measures to counteract the effects of that regime.\textsuperscript{155} The affected country could not, for

\begin{itemize}
\item\textsuperscript{152} A violation of the relevant country’s tax laws would most likely constitute a ruling that would give rise to BEPS concerns to the extent that the violation induced artificial income shifting, which would subject the ruling to Action 5’s exchange. See supra notes 133–35 and accompanying text.
\item\textsuperscript{153} OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 22 (authorizing the use of defensive measures listed in the 1998 Report); see also CÉCILE REMEUR, UNDERSTANDING BEPS: FROM TAX AVOIDANCE TO DIGITAL TAX CHALLENGES, EUR. PARLIAMENTARY RSCN. SERV., PE 642.258 4 (2019) (noting that some BEPS Actions contemplate defensive measures).
\item\textsuperscript{154} \textsuperscript{154} OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 22. However, countries routinely implement these authorized measures by means of their sovereign taxing power to combat tax avoidance caused by income shifting, regardless of whether firms avoid tax by utilizing harmful preferential regimes. Accordingly, whether or not Action 5 explicitly authorizes the use of these measures to combat tax ruling induced income shifting is irrelevant, and this Comment will assume these measures are available to combat such income shifting.
\item\textsuperscript{155} See OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 22 (authorizing countries to use defensive measures when another country fails to abolish a harmful preferential regime).
\end{itemize}
example, impose sanctions on the issuing country. However, as even the OECD admits, the prescribed defensive measures’ efficacy is questionable.\(^{156}\)

Notably, Action 5 does not discuss any direct measures to deter MNEs from utilizing violative rulings. There is no mechanism to force MNEs to disgorge unwarranted tax concessions, nor are there penalties for capitalizing on violative tax rulings. Moreover, the authorized defensive measures are inadequate to prevent MNEs from utilizing these rulings. However, in other areas of law, the OECD observes that some form of deterrence is necessary for compliance. For example, in the context of competition law, the OECD readily admits that penalties or sanctions are necessary to deter violations. A report published by the OECD notes that “[f]ines play a role in deterrence by making unlawful conduct less profitable. Breaking competition laws is profitable if it goes undetected. From the perspective of a pure profit-maximising company, it will not violate the law if the expected monetary sanctions are greater than the expected illegal gain.”\(^{157}\) The fundamental parallels between tax avoidance and violating antitrust laws suggest that a firm would deploy a similar profit maximizing analysis when considering tax avoidance. If anything, tax avoidance is an easier application of this analysis because tax avoidance is legal, making it prima facie more socially acceptable than violating antitrust law, notwithstanding any criminal sanctions associated with the latter. So, as the OECD BEPS Project does not contemplate measures that can adequately frustrate the net benefits of tax avoidance, there is only upside from utilizing favorable tax rulings, which raises suspicion as to the optimism pertaining to the anticipated behavioral responses of the transparency framework.

II. THE SHORTCOMINGS OF ACTION 5 AND THE COMPLEMENTARITY OF TRANSPARENCY AND DISGORGEMENT

Action 5’s transparency framework alone is unlikely to produce the behavioral changes contemplated and desired by the OECD. This Part provides a formal, yet approachable, economic analysis to illustrate the theoretical behavioral changes resulting from transparency. It shows that transparency alone will not create even modest behavioral changes by either

\(^{156}\) E.g., OECD, 1998 REPORT, supra note 7, ¶¶ 89, 91 (noting that “in the absence of international cooperation [in implementing defensive measures] there is little incentive for a country which provides a harmful preferential tax regime to eliminate it” because MNEs can easily shift their income to other jurisdictions and positing that while “unilateral measures are easiest for countries to adopt . . . multilateral responses . . . which are the most difficult to adopt . . . . are essential”).

MNEs or countries, but would create significant behavioral changes when accompanied by a disgorgement mechanism.

A. Expected Behavioral Responses Following Action 5’s Transparency Framework

It is first important to note that taxes affect firm decisionmaking. Like any other input cost, taxes create negative pressure on, or reduce, profit. As such, imposing taxes can affect real economic activity, such as location and investment decisions.158 The free flow of capital, goods, and services across international borders has increased MNE sensitivity, or responsiveness, to potential taxes, as MNEs can more easily alter their organizational structure to optimize tax costs.159 However, in some instances tax costs do not affect real economic activity, such as output or supply chain decisions, but still motivate firms to artificially shift their income. Although Action 5’s transparency framework is broad—as it seemingly applies to rulings involving all types of income rather than solely geographically mobile income contemplated in the 1998 Report and Action 5’s portion dedicated to preferential regimes—tax rulings typically facilitate this artificial income shifting.160

Action 5’s transparency framework alone cannot adequately combat the use of tax rulings to facilitate artificial income shifting. A country will issue a favorable ruling when the benefits of doing so exceed the costs. An MNE will artificially shift income to the issuing country when the ruling renders income shifting the profit-maximizing alternative. Action 5 will not prevent the practice of using favorable rulings to induce income shifting because neither transparency nor the authorized defensive measures will affect the ruling’s net benefits to the issuing country or the utility to the MNE.

1. In the Absence of Transparency

Acknowledging that tax costs affect firm behavior improves the analysis of tax rulings and income shifting. This subsection will first model firm and country behavior before the introduction of Action 5 and its transparency

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158 OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING 28 (2013) (“[T]ax affects decisions on where and how to invest.”).

159 Id. at 25.

160 Giraud & Petit, supra note 29, at 234 (noting that MNEs have been using transfer pricing to reduce tax liability for decades and that MNEs are “increasingly agile at locating their revenues and profits in the jurisdiction of their choosing”); Reuven S. Avi-Yonah & Haiyan Xu, Global Taxation After the Crisis: Why BEPS and MAATM are Inadequate Responses, and What Can Be Done About It 22 (U. Mich. Pub. L. & Legal Theory Rsch. Paper No. 494, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2765124 (“[A] lack of transparency in connection with certain [tax] rulings has been widely used by MNEs for artificial profit shifting.” (emphasis added)).
framework. In this model, let \( F \) be an MNE with country \( k \) source income, which was not artificially shifted to country \( k \) but is able to be artificially shifted. \( F \) must decide whether and where to artificially shift this income among a set of countries, \( S \). \( F \)'s generalized after-tax profit function is

\[
\Pi(q, t) = R(q) - C(q, t),
\]

where profit, \( \Pi \), is a function of the quantity, \( q \), of goods or services sold or other income producing property either sold or otherwise generating income for \( F \) and of taxes, \( t \), that \( F \) must pay. \( R(q) \) and \( C(q, t) \) are \( F \)'s revenue and cost functions, respectively. Moreover, for every increase in the \( F \)'s tax cost, \( F \)'s costs will increase, which is characterizable using the first order partial derivative of the cost function with respect to \( t \):

\[
\frac{\partial C(q, t)}{\partial t} > 0 \quad \forall t \in \mathbb{R}.
\]

Thus, an increase in \( F \)'s tax cost will decrease \( F \)'s profit, as

\[
\frac{\partial \Pi(q, t)}{\partial t} = -\frac{\partial C(q, t)}{\partial t} < 0 \quad \forall t \in \mathbb{R}.
\]

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161 The profit function represents the present value of \( F \)'s profit across \( n \) periods where \( n \in \{1, 2, 3, \ldots\} \) and represents the number of periods \( F \) will evaluate if it receives a ruling. This is the appropriate consideration because MNEs that shift income generally ought to consider the total value of a tax concession across all relevant periods and rulings can afford tax concessions across multiple time periods. For example, the rulings Ireland issued to Apple provided tax benefits to Apple across multiple years.

162 For example, interest earned by \( F \) is income producing property that is not sold but still produces income for \( F \).
Because $F$ seeks to maximize its after-tax profit, it will “leave” its income in country $k$ because it is assumed that $F$’s profit from leaving such income in country $k$ yields a higher profit for $F$ than if it shifted its income to any other country in $S$,$^{163}$ or

$$\Pi_k(q_k, t_k) > \Pi_i(q_i, t_i) \ \forall i \in S \setminus \{k\}.$$ $^{164}$

Suppose country $j$ wants $F$ to shift the income there rather than leave it in country $k$. Because $F$ is artificially shifting income, there is no need for $F$ to restructure its operations to shift this income, which otherwise would impose income shifting costs on $F$. So, there are no shifting costs that country $j$ would need to offset to induce the income shifting. Also, because $F$ is artificially shifting income, any incentives designed to affect real economic activity, such as manufacturing subsidies or other related state-provided assistance, will be ineffective to induce $F$ to shift its income to country $j$. As such, a tax cost reduction larger than the difference in $F$’s profit generated by leaving the income in country $k$ rather than shifting it to country $j$ is likely the only way to induce $F$ to shift its income to country $j$. To decrease $F$’s tax liability such that country $j$ becomes the profit maximizing location, country $j$ will issue a tax ruling.

In general, tax rulings are preferable to enacting favorable domestic tax law for three reasons. First, legislative changes occur slowly.$^{165}$ Second, tax rulings

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163. Absent a tax ruling, country $k$ can be the profit maximizing location for several reasons. For example, country $k$ may impose the lowest effective tax rate on the type of income at issue. Additionally, because $F$’s profit maximizing quantity is country specific, income shifting may lead to a lower profit even if there exists some other country that would impose a lower effective tax rate on the income absent a ruling.

164. The profit functions here include subscripts to denote $F$’s profit from shifting its income to a specific country. The profit maximizing quantity and tax cost also include such subscripts. While denoting the tax cost by each country is necessary because countries impose different tax costs, the profit maximizing quantity may not be country specific because this model analyzes the income shifting due to favorable tax rulings, which generally involves artificial profit shifting. Generally, artificial income shifting for tax avoidance purposes is unlikely to generate real economic effects, such as effects on the profit maximizing quantity, because tax-motivated income shifting does not typically require operational adjustments. See *What Is BEPS?*, supra note 14 (“BEPS refers to tax planning strategies . . . to artificially shift profits to low or no-tax locations where there is little or no economic activity . . .” (emphasis added)). However, because there could conceivably be different profit maximizing quantities depending on where a firm shifts its income, this comment will continue to denote the profit maximizing quantity by the location of such income.

can be targeted at a specific taxpayer while tax law changes are broadly applicable. Even if a ruling is a general ruling, it can still be targeted toward a specific type of transaction, and depending on the frequency of that transaction type, the general ruling could have the same effect as a taxpayer-specific ruling. Third, tax rulings are more discrete than a tax law change, which can mitigate any political backlash from providing a tax concession to a foreign MNE.

In the model, a tax ruling that aims to reduce $F$'s tax cost must place enough downward pressure on $F$'s tax cost to render country $j$ a more attractive income location than country $k$. More specifically, the tax concession afforded by the ruling, denoted $\Delta_t$, must reduce $F$'s tax cost to increase $F$'s profit by an amount greater than the difference between $F$'s profit in country $k$ and $F$'s pre-ruling profit in country $j$. The necessary increase can be expressed as the inequality

$$\frac{\partial \Pi(q_j,t_j)}{\partial t} \times \Delta_t > \Pi_k(q_k,t_k) - \Pi_j(q_j,t_j),$$

where the left side of the inequality is the linearly approximated change in $F$'s profit following the ruling and the right side is the difference between $F$'s profit in country $k$ and $F$'s pre-ruling profit in country $j$. The inequality can be simplified when considering that the first order partial derivative of $F$'s profit evaluated at any point will be -1, following some simplifying assumptions. That is, a one dollar increase in tax results in a one dollar decrease in after-tax profit. So,
can be expressed as the absolute value of the change in F’s tax cost following the ruling, which simplifies the inequality to

$$|\Delta t_j| > \Pi_k(q_k, t_k) - \Pi_j(q_j, t_j).$$

Therefore, when the tax concession satisfies the inequality, F will shift its income to country j instead of leaving it in country k.

Country j would offer such a concession when the benefits of F shifting its income to country j exceed any costs to country j resulting from the ruling, or

$$u_j > c_j,$$

where u_j and c_j denote the benefits to and costs incurred by country j, respectively.

These costs and benefits must be identified by evaluating actual countries’ experiences from facilitating tax avoidance. Countries primarily incur political costs by acting as tax avoidance centers, though the countries’ residents may also suffer welfare costs. Although countries generally do not

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168 The tax concession must be expressed as the absolute value because the change in F’s tax cost is a negative number.

169 For the remainder of this Comment Π_k(q_k, t_k) and Π_j(q_j, t_j) will be expressed as Π_k and Π_j, respectively.

170 Two points are worth addressing. First, it is possible that country j’s tax ruling would produce feedback effects, possibly inducing country k to issue its own tax ruling to F. It is also possible that country j could intend to issue its ruling following an intention by country k to do so. To generalize the model’s conclusions, t_k in Π_k(q_k, t_k) shall be interpreted as country k’s “best offer,” which may include a favorable ruling issued by country k.

Second, some may question the sequence of events involved; that is, country j will issue its ruling before F decides whether to shift its income there. It is natural to think that F would first have to actually shift its income before either country could or would issue a tax ruling affording favorable tax treatment to F. However, income shifting accompanied by tax rulings typically occur in the manner implicit in the model, that is, the MNE first secures a favorable ruling with a tax jurisdiction and then subsequently structures itself to utilize the ruling. See, e.g., Dina Gusovsky, Taxes, Multinational Firms & Luxembourg – Revealed, CNBC (Nov. 7, 2014, 8:57 AM), https://www.cnbc.com/2014/11/06/taxes-multinational-firms-luxembourgrevealed.html [https://perma.cc/AXT8-XLDN] (noting that, in Luxembourg, companies often first consult with the tax authority to get a tax ruling approved which then gives them “the green light” for structuring their operations to benefit from the ruling); see also id. (noting that many tax rulings are preapproved, which is “the equivalent of a foreign firm coming to the United States and arranging its tax burden with the IRS in advance”).

171 See, e.g., Brooke Harrington, Why Tax Havens are Political and Economic Disasters, ATLANTIC (July 28, 2016), https://www.theatlantic.com/business/archive/2016/07/tax-haven-curse/491411 [https://perma.cc/RZj8-ASML] (finding that acting as a conduit for tax avoidance may depress resident income through an increased cost of living). These welfare costs are externalities, as they
want to be perceived as tax avoidance centers because that perception adversely impacts their international reputation, the actual costs incurred from this reputational harm are generally negligible. Even widely publicized accounts of countries aiding tax avoidance often do not induce significant directed responses from affected jurisdictions. The benefits, however, of becoming tax avoidance centers primarily include increased tax revenues, as well as possible increases in employment and economic growth. Overall, however, countries generally receive different benefits when they induce artificial income shifting in comparison to obtaining ordinary foreign direct investment (FDI).

are not borne directly by the tax authority issuing the ruling or the MNE receiving the ruling. Therefore, it is possible that the taxing authority would not even consider such costs when deciding to issue the ruling.

See, e.g., Will Goodbody, The Apple Tax Case Appeal: All You Need to Know, RTÉ (Sept. 15, 2019, 7:44 PM), https://www.rte.ie/news/analysis-and-comment/2019/0915/1075807-apple-tax-appeal-explained [https://perma.cc/JXJ5-5APB](noting the Irish government’s “strong” denial of claims that Ireland is a tax haven); Gusovsky, supra note 172 (“A spokesman for Luxembourg’s Minister of Finance . . . strongly rejects the assertion that Luxembourg is a tax haven and said that his country fully complies with European and international law in tax matters.”). It is important to note that this Section focuses on the costs and benefits to countries in the absence of tax ruling transparency. Possible modifications to these variables following tax ruling transparency will be discussed in infra subsection II.A.2.

See, e.g., Cayman Islands Added to the EU List of Non-Cooperative Jurisdictions: Practical Impact for Cayman Island Funds and Their Managers, DECHERT LLP (Feb. 19, 2020), https://www.dechert.com/content/dechert/en/knowledge/onpoint/2020/2/cayman-islands-added-to-the-eu-list-of-non-cooperative-jurisdiction.html [https://perma.cc/YH44-NWST] (noting that the Cayman Islands’ addition to the E.U. blacklist due to the former’s tax practices “is not expected to impact Cayman Islands funds ability to raise capital from global investors”).


See, e.g., Faulhaber, supra note 34, at 311-12 (noting that countries provide low tax rates and selectively treat taxpayers to, in part, attract revenues). As mentioned, countries typically raise only a sliver of tax revenue from artificially shifted income. See, e.g., Gusovsky, supra note 172 (“[T]he Luxembourg tax on 50 million of interest income running through the country . . . would be less than $100,000.”).

Employment increases are likely slight, if not absent, because mobile income shifting does not involve significant firm investments in, for example, manufacturing plants, which would create more significant employment. See, e.g., Gusovsky, supra note 172 (noting that LuxLeaks involved companies shifting income to Luxembourg companies with, in the words of Professor Steven Plotnick, “no tangible activities”); Levin & McCain, supra note 57, at 9-10 (noting that U.S. multinationals income shifting typically involves shell companies, which have no employees and do not produce goods).

See Harrington, supra note 173 (noting the “influx of cash” and boon to jobs and revenues in countries that establish themselves as tax avoidance centers).

Such benefits include an increase in employment and new technologies. See Prakash Loungani & Assaf Razin, How Beneficial Is Foreign Direct Investment for Developing Countries?, Fin. & DEV., June 2001, at 6, 7 (describing how FDI leads to the transfer of technology and the development of the host nation’s human capital through employee training programs).
In issuing a favorable ruling to $F$, country $j$ will attempt to maximize its benefits and minimize its costs. The smaller the tax concession to $F$, the greater the difference between these costs and benefits, as a smaller concession will yield higher tax revenues and mitigate the perception that country $j$ is a tax avoidance center. Therefore, the value of the tax concession afforded to $F$ will likely be just large enough to render country $j$ the profit maximizing location.

2. Incorporating Action 5’s Tax Ruling Transparency

The previous subsection modeled the necessary conditions for a tax ruling to induce income shifting as:

$$|\Delta t_j| > \Pi_k - \Pi_j \text{ and } u_j > c_j.$$ 

This subsection incorporates the expected consequences of Action 5’s transparency framework, including the prescribed defensive measures, and adjusts these necessary conditions to account for these consequences. Although some advocates suggest that transparency will deter egregious forms of tax avoidance, there is no empirical evidence on the effect of tax ruling transparency. However, incorporating Action 5’s transparency framework into the above model does not yield any significant theoretical changes to the conditions required for a tax ruling to induce income shifting. As such, tax ruling transparency will not result in significant behavioral changes by either MNEs in utilizing or tax authorities in issuing violative tax rulings.

The OECD BEPS Project’s transparency framework has no theoretical effect on firm behavior. As demonstrated above, any favorable tax ruling decreases a firm’s tax cost. A decrease in a firm’s tax cost increases their after-tax profit. For transparency to create behavioral changes, transparency itself must frustrate the utility of the tax ruling by, for example, imposing a cost on a firm accepting the tax concession afforded by the favorable tax ruling. Because acceptance of a tax concession has no causal relation with a firm’s input costs, the only conceivable cost associated with acts of tax avoidance must be a cost to the firm’s reputation, denoted $r(\Delta t)$, which could manifest

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181 See, e.g., OECD, 2018–2019 PROGRESS REPORT, supra note 18, at 9 (noting that transparency will deter governments from offering “sweetheart” deals to foreign MNEs); Neubig, supra note 19, at 1140 (“[T]ransparency . . . will discourage the most egregious tax planning activity of MNEs . . . ”).

182 See Neubig, supra note 19, at 1150 (noting that open research opportunities include empirical analysis of government behavioral changes following greater tax ruling transparency).

183 The reputational harm to a firm accepting a favorable tax concession is expressed as a function of the magnitude of the tax concession because as the magnitude of the tax concession increases so too does the supposed egregiousness of the firm’s tax avoidance. Therefore, it is rather apparent that more egregious tax avoidance produces more expected reputational damage from that avoidance.
itself as injurious to consumer perception of the firm and thus the firm’s sales and its perceived value.184 With the incorporation of reputational harm into the above model, the tax concession would now have to satisfy

$$|\Delta t_j| - r(\Delta t_j) > \Pi_k - \Pi_j$$

for $F$ to shift its income to country $j$ rather than leaving it in country $k$. However, the reputational harm stemming from ruling-induced tax avoidance is minimal, if not nonexistent.185 As such, $r(\Delta t_j)$ roughly equals zero. So, if a tax concession satisfies

$$|\Delta t_j| > \Pi_k - \Pi_j$$

when there is no transparency, then it will satisfy

$$|\Delta t_j| - r(\Delta t_j) > \Pi_k - \Pi_j$$

when there is tax ruling transparency. Therefore, transparency alone does not discourage firms from utilizing favorable tax rulings to shift income.

Moreover, the defensive measures186 authorized by Action 5 cannot remedy transparency’s inability to affect MNE behavior. The defensive measures, which include those from the 1998 Report, primarily seek to combat tax avoidance and base erosion through enhanced CFC rules and their analogs with respect to non-corporate entities.187 These rules, in theory, stem avoidance by taxing certain types of income attributable to foreign owned entities, including income artificially shifted to utilize favorable tax rulings. As such, with Action 5’s authorization of defensive measures, there is now some probability, $\varphi$, of $F$’s residence country taking defensive measures that

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184 Birgit Huesecken, Michal Overesch & Alexander Tassius, Effects of Disclosing Tax Avoidance: Capital Market Reaction to LuxLeaks 1, 16 (Feb. 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2848757 (“Excessive tax avoidance may... lead to reputational consequences, such as consumers choosing to buy from the [tax avoiding] firm’s competitors...”).

185 One study analyzed firm share prices after the LuxLeaks disclosure of confidential tax rulings issued by Luxembourg and generally found no evidence of reputational harm to firms. See id. (manuscript at 6). Even if there is some reputational harm, the harm did not outweigh the positive effect on firm value stemming from effective tax planning, which suggests negative publicity from tax avoidance does not impose net costs on firms. Id.; see also John Gallemore, Edward L. Maydew & Jacob R. Thornock, The Reputational Costs of Tax Avoidance, 31 CONTEMP. ACCT. RSCH. 1103, 1105 (2014) (concluding that there is no empirical evidence to support the proposition that tax avoidance and tax sheltering have reputational consequences for firms).

186 See supra notes 153–55 and accompanying text.

187 OECD, 1998 REPORT, supra note 7, at 40–42.
impose some residence country effective tax rate, \( \tau \), on \( F \)'s post-ruling profit if \( F \) shifts its income to country \( j \).\(^{188}\) Now the tax concession must satisfy

\[
|\Delta t| - \varphi \tau (|\Delta t| + \Pi) > \Pi_i - \Pi,
\]

which can be simplified to

\[
(t - \varphi \tau) (|\Delta t| + \Pi) > \Pi_i. \tag{189}
\]

However, these anti-tax avoidance rules are often easily circumvented or too weak to lessen the tax benefits of income shifting.\(^{190}\) As a result, \( \tau \) is

188 The value of \( \varphi \) depends on whether \( F \)'s residence country has existing defensive measures. If \( F \)'s residence country has existing defensive measures, then \( \varphi = 1 \). If \( F \)'s residence country has not already taken defense measures, then \( \varphi \in [0, 1] \).

189 This analysis assumes \( F \) is risk neutral. This analysis also ignores the possibility that \( F \)'s residence country would take defensive measures if \( F \) were to shift its income to country \( k \).

190 See, e.g., supra notes 83–85 and accompanying text; OFF. OF TAX POL'Y, DEPT OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS 62–67 (2000) (providing various strategies by which MNEs avoid the Code’s Subpart F and concluding that Subpart F may be ineffective); EUR. COMM’N, TAX POLICIES IN THE EUROPEAN UNION: 2020 SURVEY 94 (2020) (noting that CFC rules provided in the E.U. directives could not eliminate “aggressive tax planning”); JOSEPH ISENBERGH & BRENT WELLS, INTERNATIONAL TAXATION 370 (4th ed. 2020) (“[T]he Subpart F regime as currently constructed does generally allow broad latitude to the U.S. [MNEs] to engage in the full range of base erosion strategies between its [CFCs] when those strategies are directed at the foreign-to-foreign context”); Fleming Jr. et al., supra note 78, at 1181 (noting that the TCJA did not alter the check-the-box regulations, which allow taxpayers to avoid Subpart F and taxation under § 951A); Scott D. Dyreng, Fabio B. Gaertner, Jeffrey L. Hoopes & Mary E. Vernon, The Effect of U.S. Tax Reform on the Tax Burdens of U.S. Domestic and Multinational Corporations 19 (June 2020) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3620102 (“[F]irms that were targeted by GILTI [global intangible low-tax income]... appear to pay no more federal tax on foreign earnings in the post-TCJA period than they did in the pre-TCJA period.”); see also OECD, DESIGNING EFFECTIVE CONTROLLED FOREIGN COMPANY RULES: ACTION 3 – 2015 FINAL REPORT 9 (2015) (noting that many “existing CFC rules... have design features that do not tackle BEPS effectively” and recommending designs for more effective CFC rules); Kadet, supra note 151, at 52–53 (explaining that Action 3 does not proffer any minimum standards that would create effective CFC rules); Michael C. Durst, The OECD’s BEPS Project and Lower-Income Countries, 90 TAX NOTES INT’L 157, 1168–69 (2018) (noting that political pressures have rendered CFC rules “relatively toothless” and the OECD “ma[de] no move toward advocacy of a global network of strict CFC rules as a primary goal of the BEPS project”); Barry Larking, What the World Thinks of Pillar 2, 98 TAX NOTES INT’L 185, 187 (noting a general consensus implying that existing CFC rules cannot combat profit shifting); Sebastian Beer, Ruud de Mooij & Li Liu, International Corporate Tax Avoidance: A Review of the Channels, Magnitudes, and Blind Spots 7 (Int’l Monetary Fund, Working Paper No. 18/168, 2018) (noting the ability of MNEs to avoid residence country CFC rules through corporate inversions); Letter from Jeffery M. Kadet, Professor of Law, Univ. of Wash. Sch. of L., to the Task Force on the Digit. Econ., Org. for Econ. Cooperation & Dev. 11 (Oct. 11, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3053366 (“It is clear that CFC and transfer pricing rules have been ineffective in either curbing MNE enthusiasm for profit shifting or in seriously countering its effects.”); Daniel Bunn, Ripple Effects from Controlled Foreign Corporation Rules, TAX FOUND. (June 13, 2019), https://taxfoundation.org.controlled-foreign-corporation-rules-
negligible, and thus $F$, despite the possibility of encountering Action 5’s defensive measures, will shift its income to country $j$ when

$$\left| \Delta t_j \right| > \Pi_k - \Pi_j.$$ 

As such, residence country defensive measures will not deter firms from utilizing favorable tax rulings to avoid tax by shifting income.\(^{191}\)

The Action 5 transparency framework may induce some country behavioral changes, although the expected changes are negligible. For instance, greater transparency may increase countries’ possible political costs. The country cost parameter in the model above primarily consisted of political costs. With greater tax ruling transparency, the expected political costs are greater than in a scenario where there is no transparency.\(^{192}\) So, considering the above model, Action 5 will increase the costs to country $j$ from issuing a ruling by some amount $\Delta c_j$. As such, country $j$ will issue the ruling when

$$u_j > c_j + \Delta c_j.$$ 

However, widespread tax avoidance activity, let alone isolated instances of favorable tax treatment, does not generally elicit any significant directed responses from affected jurisdictions.\(^{193}\) Moreover, given that such concessions would likely deviate from OECD BEPS Project Actions, affording such concessions would violate the country’s commitment to the OECD BEPS Project. Generally, violations of international agreements and
collaborative efforts adversely impact a country’s reputation. But because the OECD BEPS Project is soft law, deviations from its terms would not cause significant reputational damage. As such, the political costs resulting from transparency will likely only deter countries from issuing egregiously favorable tax rulings. But the prevalence of such rulings is small, if not negligible, and a ruling need not be extraordinarily egregious to induce a foreign MNE to shift income to that jurisdiction. As such, \( \Delta c_j \) will generally be negligible such that it will approximately equal zero. So, if the ruling satisfies

\[
u_j > c_j,
\]

then it too will also satisfy

\[
u_j > c_j + \Delta c_j.
\]

Therefore, heightened political costs and pressures from issuing violative tax rulings in a scenario with transparency are insufficient to deter countries from issuing such rulings.

Moreover, even if increased transparency lessens the secretive nature of issued tax rulings, tax rulings are still the ideal method to induce income shifting. As mentioned, countries hoping to induce income shifting favor tax rulings, in part, because they can be issued more discretely than amending domestic tax law. Although tax ruling transparency certainly reduces this secrecy, tax rulings are nevertheless effective at attracting income shifting because of the other advantages that they have over tax law changes. In addition, even with transparency requirements, tax rulings still remain more discrete than domestic tax law changes because Action 5 requires an information exchange with only a

\[194\] See Timothy Meyer, Power, Exit Costs, and Renegotiation in International Law, 51 HARV. INT’L.L.J. 379, 394–95, 397 (2010) (equating exit provisions to soft law agreements, noting that exit provisions in international agreements allow for countries to leave such agreements without suffering reputational harm, and implying that the distinction between exit and violations of agreements is relevant only if there is a desire to renegotiate the existing agreement); see also Andrew T. Guzman & Timothy L. Meyer, International Soft Law, 2 J. LEGAL ANALYSIS 171, 183–84 (2010) (noting that one reason why states may choose soft law because they prefer to lower the costs of avoiding their obligations stemming from the agreement under certain conditions). Additionally, it appears that inadequate compliance with Action 5 does not result in material reputational costs to noncompliant countries as the most recent BEPS Progress Report indicates that thirty-two jurisdictions have not yet implemented the OECD’s recommended changes to their exchange practices. OECD, 2019–2020 PROGRESS REPORT, supra note 18, at 16. Given the extent to which the OECD and BEPS Project supporters champion transparency as a highly effective tool to stem the use of rulings to afford unwarranted tax concessions, one would expect that, assuming reputational costs of noncompliance were material, these countries would have already implemented the OECD’s recommendations.

\[195\] See supra notes 165–67 and accompanying text.

\[196\] See supra notes 165–66 and accompanying text.
limited number of parties. Therefore, even when subject to greater tax ruling transparency requirements, countries are unlikely to use an alternative mechanism to induce foreign MNE income shifting.

Finally, Action 5’s defensive measures will not affect the supply of tax rulings. After F’s residence country takes defensive measures, country j may no longer be the optimal location for F to continue to shift its income. If F then begins shifting its income elsewhere, country j will not fully realize the estimated benefits of F’s income shifting, u. More specifically, country j will not realize some portion α ∈ [0, 1] of these benefits. As the probability of F’s residence country taking defensive measures is φ, the ruling’s benefits to country j must satisfy

\[ u_i - \varphi u_i > c_j, \]

which can be simplified to

\[ (1 - \varphi \alpha)u_i > c_j. \]

However, to actually reduce the benefits to country j from issuing a favorable tax ruling, the defensive measures must deter income shifting. Because they do not, defensive measures will not induce F to shift its income elsewhere. Therefore, α is approximately zero. So, if the benefits to country j satisfy

\[ u_i > c_j, \]

then they will also satisfy

\[ (1 - \varphi \alpha)u_i > c_j. \]

As such, Action 5’s defensive measures will not deter countries from issuing violative tax rulings.

Furthermore, while transparency not only fails to limit the prevalence of favorable tax rulings, it may also produce a more perverse consequence. The OECD BEPS Project’s transparency framework can make countries that compete with each other through taxes to attract foreign investment aware of one another’s rulings. More publicly available rulings better illuminate the

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197 See OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, at 53 tbl.53.
198 As with MNEs, this analysis assumes that countries are risk neutral.
199 OECD, 1998 REPORT, supra note 7, ¶ 27; Faulhaber, supra note 34, at 311.
200 For general rulings, the OECD suggests that the granting country make the ruling publicly available. OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 141. For taxpayer-specific rulings, the OECD suggests the issuing country share the ruling with the relevant countries, which depends on the type of ruling issued. Id.
types rulings that may induce foreign MNEs to shift income. As such, transparency can actually uncover opportunities and methods for countries to compete for foreign MNE income through tax rulings. Because the transparency framework requires countries to exchange the subject matter of the ruling and the transaction amount, countries can more effectively “bid” for the foreign MNE’s income. As a result, transparency can actually turn tax rulings into a global auction, increasing the prevalence of favorable tax rulings.

B. The Complementarity of Transparency and Disgorgement

Alone, Action 5’s tax ruling transparency likely elicits negligible or no behavioral responses from either MNEs or countries. Coupled with a disgorgement mechanism, however, transparency creates significant behavioral changes, because their combination frustrates the utility of favorable tax rulings. In fact, following the implementation of Action 5 and E.U. tax ruling transparency measures, one commentator concluded that enhanced transparency would bolster E.U. state aid law enforcement in tax-related cases. The above model can explain these expected effects.

1. Complementarity and the Magnitude of the Tax Concession

Transparency and disgorgement together tend to affect firm behavior rather than country behavior. In the above model, without transparency or the possibility of disgorgement, or with transparency alone, F will shift its operations to country j if the tax concession satisfies

$$|\Delta_t| > \Pi_k - \Pi_j.$$ 

However, the possibility that F will be forced to disgorge country j’s offered tax concession alters this inequality. By creating the possibility of disgorgement, there is some probability $p \in [0, 1]$ that F can keep the afforded

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201 Id. ¶¶ 130–31 (describing information exchanges); id. annex C at 74–79 (providing template forms with which to conduct exchanges).

202 Cf. Alexandre Mas, Does Disclosure Affect CEO Pay Setting?: Evidence from the Passage of the 1934 Securities and Exchange Act 1 (Indus. Rel. Section, Princeton Univ., Working Paper No. 632, 2019), https://dataspace.princeton.edu/handle/88435/dsp000k225d92n (noting that executive compensation increased following mandatory public disclosure of compensation even though the purpose of disclosure was to serve as a check on the level of compensation).

concession.\textsuperscript{204} The probability $p$ is a function of both the magnitude of the tax concession, $|\Delta_t|$, and the characteristics of the ruling, denoted $y$, with the latter primarily contemplating the degree of the ruling’s deviation from the issuing country’s normal tax laws or OECD standards, including the OECD BEPS Project Actions.\textsuperscript{205} With transparency and the possibility of disgorgement, the expected value of the tax concession—the magnitude of the concession multiplied by the probability $F$ can keep the concession—must be greater than the difference in profit from shifting income to country $j$, rather than merely the concession’s magnitude in the scenario where there is no disgorgement mechanism. Accordingly, the tax concession must instead satisfy

$$|\Delta_t| \times p(|\Delta_t|, y) > \Pi_k - \Pi_i$$

to induce $F$ to shift its income to country $j$.\textsuperscript{206}

The probability that a firm can keep the afforded tax concession is inversely related to the magnitude of the concession. This is because a relatively larger tax concession is prima facie more violative of the disgorgement mechanism’s substantive guidelines, especially in the context of E.U. state aid law and the substantive backdrop of a hypothetical BEPS-focused disgorgement mechanism. In the E.U. state aid law context, any increase in the magnitude of the tax concession is prima facie more anticompetitive and thus more likely subject to disgorgement.\textsuperscript{207} The same is expected under a hypothetical BEPS-focused disgorgement mechanism. As the magnitude of the tax concession increases, the ruling is more likely to give rise to general BEPS concerns because it would be more likely to induce artificial profit shifting. This type of income shifting is the primary focus of the OECD BEPS Project.\textsuperscript{208} As a result, a larger tax concession would more likely be subject to disgorgement. Therefore, relatively larger tax concessions

\textsuperscript{204} See, e.g., Allison Christians, \textit{Friends with Tax Benefits: Apple’s Cautionary Tale}, 78 TAX NOTES INT’L 1031, 1034 (2015) (noting that the E.U. state aid case against Ireland “raises the stakes” for MNE tax planning as there is reason to doubt that privately arranged deals will survive scrutiny).

\textsuperscript{205} The interplay between transparency and the content of the ruling is discussed in infra subsection II.B.2.

\textsuperscript{206} The remainder of this subsection will only consider the tax concession’s magnitude to analyze transparency and disgorgement. Consideration of the content of the ruling is discussed infra subsection II.B.2.

\textsuperscript{207} As mentioned, E.U. state aid law generally disallows E.U. Member States to grant any forms of aid or subsidies that “distort[]” competition among market participants. See TFEU, supra note 25, art. 107(1).

\textsuperscript{208} See \textit{What Is BEPS?}, supra note 14 (“Countries now have the tools to ensure that profits are taxed where economic activities generating the profits are performed and where value is created.”).
are prima facie more violative of the relevant disgorgement mechanism's substantive backdrop.

The effect of the concession's magnitude on the probability that an MNE can keep the afforded tax concession limits the expected value of the concession to some finite number, regardless of its actual value. Because the probability that a firm can keep the afforded concession is inversely related to the magnitude of the concession, the expected value will be "bounded below" some number. That is, there exists some number by which the expected value of a given concession afforded by a tax ruling cannot exceed as \(|\Delta t_j|\) increases from zero to infinity. If this number is less than difference in profit between the possible income locations, then \(F\) will not shift its income regardless of how large \(|\Delta t_j|\) is.

A simple numerical example illustrates this point. Consider \(p\) as only a function of \(|\Delta t_j|\), or \(p(\Delta t_j)\). Further, let \(p(\Delta t_j)\) be defined as

\[
p: [0, \infty] \to [0, 1] \quad \text{given by} \quad p(\Delta t_j) = \frac{1}{1 + |\Delta t_j|}.
\]

Accordingly, as \(|\Delta t_j|\) increases from 0 to infinity, the probability that \(F\) can keep the tax concession afforded by the ruling ranges from 1 to 0. The magnitude of the tax concession must now be multiplied by \(p(\Delta t_j)\) to determine the expected value of the concession to \(F\). This can be expressed as a function, denoted \(V(\Delta t_j)\) given by

\[
|\Delta t_j| \times p(\Delta t_j) = \frac{|\Delta t_j|}{1 + |\Delta t_j|}.
\]

Similar to \(p(\Delta t_j)\), \(V(\Delta t_j)\) ranges from 0 to 1 as \(|\Delta t_j|\) increases from 0 to infinity. In other words, \(V(\Delta t_j)\) is bounded below 1. Therefore,

if \(\Pi_k - \Pi_j > 1\), then \(V(\Delta t_j) < \Pi_k - \Pi_j\)

for all tax concessions afforded by a ruling, even if the concession's dollar value is infinite. As such, a tax ruling would not be able to induce \(F\) to shift its income to country \(j\) rather than leaving it in country \(k\).

This example is generalizable to other instances where \(p(\Delta t_j)\) is similarly expressed. Let \(p(\Delta t_j)\) be given as \(\frac{1}{1 + z|\Delta t_j|}\) and \(V(\Delta t_j)\) be given as \(\frac{|\Delta t_j|}{1 + z|\Delta t_j|}\), where \(z > 0\) although it is likely that \(z > 1\). Accordingly, \(p(\Delta t_j)\) still
ranges from 1 to 0 as $|\Delta t_j|$ increases from 0 to infinity, and $V(|\Delta t_j|)$ ranges from 0 to $\frac{1}{z}$ as $|\Delta t_j|$ increases from 0 to infinity. Similar to the previous example, $V(|\Delta t_j|)$ is now bounded below $\frac{1}{z}$, and a tax ruling cannot induce $F$ to shift its income to country $j$ if

$$\frac{1}{z} < \Pi_k - \Pi_j.$$  

This theoretical limit on the expected value of any given tax concession, however, does not incorporate an additional constraint accounted for by the model. Country $j$ will issue a ruling to $F$ only if $u_j > c_j$. As mentioned, the benefits to country $j$ from issuing the ruling are primarily increased tax revenues, as country $j$ can still extract some tax from $F$ despite the afforded concession. However, a disgorgement mechanism requires an increase in the magnitude of the afforded tax concession to induce income shifting. Consequently, the disgorgement mechanism requires a larger outlay by country $j$ that reduces country $j$'s possible benefits from $F$'s income shifting relative to a situation where there is no such mechanism. If the necessary tax concession exceeds country $j$'s net benefits, then country $j$ will not issue a ruling to induce income shifting. This constrains the maximum possible tax concession as it cannot exceed the net benefits to country $j$. So, $|\Delta t_j|$ can only range from 0 to $(u_j - c_j - \varepsilon)$, where $\varepsilon$ is some arbitrarily small positive number. Because $(u_j - c_j - \varepsilon)$ is the maximum possible value of $|\Delta t_j|$, $V(u_j - c_j - \varepsilon)$ must exceed $\Pi_k - \Pi_j$ for a tax ruling to induce income shifting. Therefore, even in instances where

$$\frac{1}{z} > \Pi_k - \Pi_j,$$

if

$$\Pi_k - \Pi_j > V(u_j - c_j - \varepsilon),$$

then a tax ruling will be unable to induce income shifting. Because the possibility of disgorgement requires a larger concession, it is more likely that the magnitude of this concession required to induce income shifting will exceed $(u_j - c_j - \varepsilon)$ than in a scenario without a disgorgement mechanism. Accordingly, disgorgement can frustrate tax ruling-induced income shifting.

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210 The inclusion of $\varepsilon$ ensures that the maximum possible offered tax concession does not completely eliminate the net benefits to country $j$ from issuing the ruling. This would render country $j$ indifferent to offering the ruling.
by effectively inhibiting the satisfaction of the necessary conditions for ruling-induced income shifting.

The above conclusions have not considered the effect of tax ruling transparency. Without transparency, the body responsible for seeking disgorgement does not as productively identify tax rulings that may violate substantive guidelines with which rulings must comply. In the context of E.U. state aid, for instance, without disclosure or notification by the issuing country, the enforcing body needs to either receive a tip from a third party or have suspicion leading to a serendipitous discovery of a violative tax ruling.\footnote{211}{See Mason, supra note 27, at 455 (explaining the Commission’s investigative procedure when it suspects a Member State has granted “so-called unnotified aid”); e.g., Giraud & Petit, supra note 29, at 233 (observing the Commission’s increased ruling-related state aid investigations following LuxLeaks.)} Tax ruling transparency gives the enforcing body full and immediate access to all issued tax rulings. Accordingly, transparency increases the enforcing body’s sensitivity to the magnitude of the afforded tax concession relative to a situation where there is no transparency. This, in turn, reduces the number below which the maximum expected value of a tax concession is bounded.

Using the generalized example of the expected value function above, transparency helps minimize this threshold by affecting the scalar value \(z\). In the example, the expected value of the tax concession is bounded below \(\frac{1}{z}\) as \(|\Delta t_j|\) increases from 0 to \((u_j-c_j-\varepsilon)\); in other words, the expected value of the tax concession will never exceed \(\frac{1}{z}\). As mentioned, the relevant enforcing body’s sensitivity to the size of the tax concession afforded by the ruling increases when tax ruling transparency complements the disgorgement mechanism. As such, transparency increases the value \(z\) to \(\hat{z}\). As such, transparency changes the expected value function to

\[\hat{V}(|\Delta t_j|) = \frac{|\Delta t_j|}{1+|\Delta t_j|}\]

Accordingly, transparency thus decreases the maximum expected value of an infinitely large tax concession afforded by a tax ruling as \(\frac{1}{z}\) is strictly greater than \(\frac{1}{\hat{z}}\). Moreover, because the maximum concession cannot exceed \((u_j-c_j-\varepsilon)\) regardless of tax ruling transparency,

\[V(u_j-c_j-\varepsilon) > \hat{V}(u_j-c_j-\varepsilon)\].
As such, the difference in profit between the two possible income locations must be smaller for a tax ruling to induce income shifting. Accordingly, as long as there are instances where

\[ V(u_j - c_j - \varepsilon) > \Pi_k - \Pi_j \text{ and } \tilde{V}(u_j - c_j - \varepsilon) < \Pi_k - \Pi_j, \]

transparency will reduce the number of instances where a tax ruling can induce income shifting when complementing a disgorgement mechanism.

As mentioned, the above examples provide only one conception about what the function \( p(|\Delta t_j|) \) could be. But the true probability function need not take the exact form in the provided examples to stem tax ruling-induced income shifting. Because the probability that an MNE can keep the tax concession afforded by a ruling decreases as the magnitude of the ruling increases, the expected value of the concession will always be bounded below some number. As long as this number is less than the difference in pre-ruling profit between two locations, a ruling will not induce income shifting. As such, transparency coupled with a disgorgement mechanism produces a set of instances where tax rulings are no longer an effective means to induce income shifting, and it can be expected that transparency will reduce the number of instances where rulings can induce income shifting.

2. Complementarity and the Content of the Tax Ruling

Thus far, the discussion has analyzed the impact of tax ruling transparency on a disgorgement mechanism considering only the magnitude of the tax concession afforded. However, as previously stated, the probability that a firm can keep the afforded tax concession is not only a function of the concession's monetary value but also the subject matter of the ruling itself. In other words, how the ruling decreases an MNE's tax liability also influences this probability.

The content of a ruling influences the probability that an MNE can keep a tax concession afforded by a ruling. Consider the following example. Suppose a non-U.S. MNE, F. Corp., wants to shift interest income to the United States to avoid current taxation on this income in its home country. To do so, suppose F. Corp. incorporates a subsidiary in the United States, U.S. Sub. F. Corp. contributes cash to U.S. Sub upon its incorporation, and U.S. Sub proceeds to open a bank account in the U.S. and deposit the cash in the account. Suppose further that F. Corp. shifted this interest income because the IRS issued a ruling simply providing that the interest income received by U.S. Sub is not subject to U.S. tax. Such a ruling would significantly deviate
from clearly defined U.S. tax law. Accordingly, if this ruling were subject to disgorgement and U.S. tax law was part of the disgorgement mechanism's substantive backdrop for this particular case, the probability that F. Corp. and U.S. Sub can keep the tax concession would certainly be very low, regardless of the size of the concession.

As such, the content of the ruling warrants consideration when determining the probability that a firm can keep an afforded concession. Considering the generalized example of a probability function in the previous subsection, the content of the ruling imposes a new variable \( y \), which can be considered a function itself whose value is determined by the content of the ruling at issue and whose value affects the probability that an MNE can keep the afforded tax concession. As such, this probability is now expressed in its entirety as

\[
p(|\Delta t_j|, y) = \frac{1}{1 + yz|\Delta t_j|}
\]

This probability ranges from 1 to 0 as \(|\Delta t_j|\) ranges from 0 to infinity. Accordingly, the expected value of a tax concession afforded by a ruling is

\[
V(|\Delta t_j|, y) = \frac{|\Delta t_j|}{1 + yz|\Delta t_j|}.
\]

Now, instead of \( V(|\Delta t_j|, y) \) ranging from \( 0 \) to \( \frac{1}{z} \) as \(|\Delta t_j|\) ranges from 0 to infinity, \( V(|\Delta t_j|, y) \) ranges from 0 to \( \frac{1}{yz} \). Accordingly, the value \( y \) has significant importance for determining the theoretical maximum expected value of a tax concession and thus whether tax rulings can induce income shifting, regardless of the magnitude of the afforded concession and relevant enforcement body's sensitivity to this magnitude.

The content of the ruling’s effect on the probability that an MNE can keep an afforded tax concession depends on the extent to which the ruling identifiably deviates from the applicable rules underlying the disgorgement mechanism. This in turn depends on how well-defined these rules are. If the

\[\text{212 See I.R.C. } \S\text{ 61(a)(4) ("[G]ross income . . . includ[e][es] . . . [i]nterest . . . ."); Treas. Reg. } \S\text{ 1.61-7(a) (as amended in 1966) ("As a general rule, interest received by or credited to the taxpayer constitutes gross income and is fully taxable. Interest income includes interest on . . . bank deposits . . . .").}
\]

\[\text{213 It is important to distinguish between the two scalar values in this function. The values } z \text{ and } \hat{z} \text{ capture the relevant enforcing body’s sensitivity to the magnitude of the tax concession. The two values } z \text{ and } \hat{z} \text{ are exhaustive of what this scalar value can be, as } z \text{ applies when there is no tax ruling transparency and } \hat{z} \text{ applies when there is tax ruling transparency, such as in a hypothetical BEPS-focused disgorgement mechanism incorporating Action 5. The value } y \text{, while implicitly serving as a scalar value, can be considered a function of the content of the ruling by which the content imputes some numerical value for } y. \text{ Accordingly, } y \text{ depends on the particular tax ruling at issue and theoretically has infinite possible values.}
\]
applicable tax rules are vague and the ruling deviates only slightly, the value \( y \) will be relatively small. Because in the absence of transparency the maximum value of \( V(\mid \Delta t_j \mid, y) \) is \( \frac{1}{yz} \) (ignoring the constraint on the magnitude of the tax concession of \((u_j - c_j - \epsilon)\)), a relatively small value \( y \) imputes a relatively large maximum value of \( V(\mid \Delta t_j \mid, y) \). This would necessarily lead to more instances where a tax ruling can induce income shifting. Conversely, if the disgorgement mechanism has more well-defined rules, even minor deviations would impute a relatively high value of \( y \). Considering the example of F. Corp. and U.S. Sub, if the ruling more subtly immunized the interest income from tax by, for example, recasting the interest as some other item of income excluded from “gross income” under I.R.C. \( \S \) 61, the deviation from the applicable U.S. tax law would be less extreme relative to the original example. However, such a ruling would still violate U.S. tax law because the transaction between the bank and U.S. Sub can only be properly characterized as a payment of interest on a bank deposit. And if U.S. tax law served as part of the disgorgement mechanism’s substantive backdrop in that case, even this subtler deviation would impute a relatively large value of \( y \) and, as such, a relatively low maximum value of \( V(\mid \Delta t_j \mid, y) \). Accordingly, the more well-defined the substantive rules undergirding the relevant disgorgement mechanism, the more identifiable a ruling’s deviations from these rules and the less likely that ruling can be used to induce income shifting.

Transparency essentially compounds the ruling content’s effect on the probability that an MNE can keep an afforded concession. In general, tax ruling transparency provides the relevant enforcing body with all issued rulings that meet the exchange requirements. In the OECD BEPS Project context, Action 5 requires this exchange of tax rulings, as well as information such as the type of ruling issued\(^{214} \) and a short summary of the issue covered by the ruling.\(^{215} \) Action 5 also recommends exchanging additional information including the value of the transaction at issue in the ruling and the recipient entity’s profit.\(^{216} \) Similar to the effect transparency has with respect to the magnitude of the afforded concession, greater transparency pertaining to the content of the ruling effectively grants the relevant enforcement body greater access to issued rulings and allows them to more effectively scrutinize rulings’

\(^{214} \) In other words, the issuing country must identify which of the six categories of rulings subject to exchange the issued ruling corresponds to.
\(^{215} \) See supra note 145 and accompanying text.
\(^{216} \) OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, annex C at 75-76.
content. Accordingly, the enforcement body’s sensitivity to rulings’ content increases and each issued ruling is prima facie less likely to withstand this body’s examination.

Transparency’s effect on the enforcement body’s sensitivity to rulings’ content decreases the expected value of any given tax concession. In the presence of transparency, the value $y$ for the particular ruling increases to $\hat{y}$ such that $y > \hat{y}$. Accordingly, the expected value function in the presence of transparency must incorporate this effect on the value $y$, and therefore this function can be expressed as

$$\hat{V}(|\Delta t_j|, \hat{y}) = \frac{|\Delta t_j|}{1 + \hat{y}|\Delta t_j|}.$$ 

This function is therefore bounded below as $|\Delta t_j|$ ranges from 0 to infinity. Moreover, transparency reduces the expected value of the maximum concession that can be afforded as

$$V((u_j - c_j - \varepsilon), y) > \hat{V}((u_j - c_j - \varepsilon), \hat{y}),$$

notwithstanding transparency’s effect on the relevant enforcing body’s sensitivity to the magnitude of the afforded concession. Similar to transparency’s effect on the sensitivity to the magnitude of the afforded concession, its effect with respect to the content of the ruling thus necessitates a smaller difference in profit between two locations to induce income shifting. As such, as long as there are instances where

$$V((u_j - c_j - \varepsilon), y) > \Pi_k - \Pi_j,$$

and

$$\hat{V}((u_j - c_j - \varepsilon), \hat{y}) < \Pi_k - \Pi_j,$$

transparency’s effect with respect to the content of rulings will reduce the number of instances where rulings can induce income shifting.

Even if the true probability function does not take the same form expressed throughout this Section, in the context of a hypothetical BEPS-focused disgorgement mechanism, the introduction of a transparency framework comparable to Action 5’s will reduce the number of instances where a tax ruling can induce income shifting. Whatever the true probability function’s construct, transparency’s effect with respect to the content of the ruling will produce the same result because the content of the ruling affects whether a ruling can stand after examination. Without enhanced disclosure, it
is more difficult to uncover the existence of rulings and easier for countries to issue vague rulings that can both induce income shifting and avoid detection by the disgorgement mechanism’s enforcement body. With enhanced disclosure, it becomes easier to both discover the existence of issued rulings and compare the rulings’ subject matter with the relevant substantive backdrop of the disgorgement mechanism. This results in more effective identification of those rulings whose characteristics violate this backdrop and lead to BEPS issues. Therefore, enhanced disclosure of ruling content will also help to decrease the efficacy of using rulings to induce income shifting and serves as another means by which tax ruling transparency complements disgorgement.

III. IMPLEMENTING A BEPS-FOCUSED DISGORGEMENT MECHANISM

The preceding section demonstrated the theoretical ineffectiveness of transparency alone and the theoretical effectiveness of pairing transparency and a disgorgement mechanism. To effectuate the expected behavioral changes of the OECD BEPS Project and in particular Action 5’s transparency framework, a BEPS-focused disgorgement mechanism should be implemented. Adhering to this proposal is realistic because a similar mechanism exists to enforce E.U. state aid law. Although E.U. state aid law’s procedural aspects are advantageous, its substantive aspects are not well suited to handle the issues contemplated by the OECD BEPS Project because tax ruling-induced income shifting arguably complies with state aid law. The proposed disgorgement mechanism, while procedurally analogous to E.U. state aid law enforcement, will use the issuing country’s tax laws and the substantive guidelines of the OECD BEPS Project and other OECD guidance to reduce the prevalence of tax ruling-induced income shifting.

A. An Analysis of E.U. State Aid Law

In general, E.U. state aid law deals with competition among E.U. Member States. State aid law effectively limits the extent to which Member States can subsidize business to prevent the distortion of competition within the E.U. internal market. Although state aid law initially aimed to prevent

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217 See supra notes 24–27 and accompanying text.
218 Mason, supra note 27, at 451.
219 Ana Pošćić, Procedural Aspects of EU State Aid Law, in PROCEDURAL ASPECTS OF EU LAW 490, 490 (Dunja Duić & Tunjica Petrašević eds., 2017) (“In EU law, any aid, which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods, is prohibited, as far as it affects trade between Member States.”).
protectionism, it now covers harmful tax competition practices, including inappropriate uses of tax rulings.220

1. Substantive State Aid Law and Its Application to Tax Rulings

The Treaty on the Functioning of the European Union (TFEU) describes state aid as “any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods.”221 Although the TFEU states that such state aid “shall, in so far as it affects trade between Member States, be incompatible with the internal market,” it does not prohibit all subsidies provided by Member States.222 Some measures are explicitly deemed compatible with the internal market223 while others are considered potentially compatible.224 The European Commission is the body responsible for enforcing state aid law and challenging aid’s compatibility with the internal market.225

The European Commission and E.U. courts use a four-element test to determine whether a governmental measure constitutes state aid.226 First, the measure must be a state intervention or a use of state resources.227 Second, the measure must be liable to affect trade between Member States.228 Third, the measure must provide a “selective advantage” to the recipient.229 Finally, the measure must “distort or threaten to distort competition.”230

The third element, selective advantage, is generally subdivided into its component parts: selectivity and advantage. A measure is selective when directed at specific undertakings or types of goods.231 Selectivity can be either de jure or de facto depending upon how the Member State grants the measure.232 A measure provides an advantage when it bestows an economic

220 See Commission Notice on State Aid, supra note 26, ¶ 170 (noting that tax rulings must conform to state-aid law to avoid “confer[ring] a selective advantage”); accord Mason, supra note 27, at 452.
221 TFEU, supra note 25, art. 107(1).
222 Id.
223 See id. art. 107(2) (outlining categories of state aid deemed “compatible with the internal market,” such as aid to rectify damage from natural disasters).
224 See id. art. 107(3) (outlining categories of state aid which “may be considered to be compatible with the internal market,” such as aid to promote economic development in poorer regions).
225 TFEU, supra note 25, art. 108(1).
227 Id.
228 Id.
229 Id.
230 Id.
231 Pošćić, supra note 219, at 490.
232 See Commission Notice on State Aid, supra note 26, ¶¶ 121-22.
benefit only available through state intervention in an undertaking. The European Commission generally uses the “market economy operator” test to identify an advantage. Under this test, a Member State confers an advantage when it has not “acted as a market economy operator would have done in a similar situation.” In other words, the test asks whether a private investor could have been induced to make the same investment as the Member State.

Tax rulings are regulated by state aid law, but they are not prima facie violative of it. Disagreements over the subject matter of tax rulings do occur between the European Commission and Member States, however, and disputes usually focus on selectivity and advantage. According to the European Commission, a tax ruling may confer an advantage when it decreases the ruling recipient’s tax liability below the level that would result from an ordinary application of the Member State’s tax laws. As a result, the Commission often uses the Member State’s regularly applied tax regime as the baseline for determining the existence of an advantage. Some have noted that once the European Commission finds a tax ruling confers an advantage, a finding of selectivity naturally follows.

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233 See id. ¶ 74.
234 Id. ¶ 75 (emphasis omitted).
235 Id. ¶ 76.
236 See id. ¶ 74; accord Mason, supra note 27, at 452.
237 See Commission Notice on State Aid, supra note 26, ¶ 169 (noting that Member States can provide “legal certainty and predictability” to their taxpayers through tax rulings).
238 See, e.g., Case T-760/15, Kingdom of the Neth. v. Comm’n, ECLI:EU:T:2019:669, ¶ 128 (Sept. 24, 2019) (“[T]he Netherlands and Starbucks do not dispute the assessment made by the Commission regarding [the first, second and fourth elements of the state aid analysis] . . . . The[ir] first four pleas . . . . seek, in essence, to call into question the Commission’s finding that [the challenged tax ruling] conferred a selective advantage . . . .”); see also Mason, supra note 27, at 452 (“Under the current state of development of EU law, tax subsidies easily satisfy all the elements of state aid except for advantage and selectivity . . . .”); accord Lee A. Sheppard, News Analysis, The Cracks in the European Commission’s Apple Case, 154 TAX NOTES 55, 60-61 (2017) (noting that “[i]n most tax cases, the sole question is selectivity” and although a Member State’s tax rulings are not per se selective, “[t]ax rulings are the primary mechanism to grant advantageous deals to taxpayers”); Kyle Richard, Are All Tax Rulings State Aid? Examining the European Commission’s Recent State Aid Decisions, 18 HOUS. BUS. & TAX L.J. 1, 15-16 (2018) (noting that, in state aid cases challenging Member State tax rulings, advantage and selectivity are the only elements in dispute).
239 See Commission Notice on State Aid, supra note 26, ¶ 170.
240 Mason, supra note 27, at 453. In addition, the Commission has recently embraced the “arm’s length” standard to determine whether a tax ruling provides an advantage. See Richard, supra note 238, at 16; see also Ruth Mason, Special Report, Tax Rulings as State Aid – Part 4: Whose Arm’s-Length Standard?, 155 TAX NOTES 947, 951 (2017) (describing the use of an arm’s length standard in recent tax ruling state aid cases involving transfer pricing and profit allocation). The arm’s length standard is a recent development in state aid law, and its use has garnered significant criticism. See id. at 951, 963 (noting the Treasury’s claims that the arm’s length standard undermines the BEPS Project).
241 See U.S. DEPT. OF TREASURY, THE EUROPEAN COMMISSION’S RECENT STATE AID INVESTIGATIONS OF TRANSFER PRICING RULES 8 (2016) (noting that in the recent significant state
In recent years, the European Commission has increased the number of state aid cases concerning tax rulings. Some high-profile cases involved MNEs such as Apple, Starbucks, and Fiat. In the Apple state aid case, involving the rulings described earlier, the European Commission initially ordered Ireland to recover approximately €13 billion in “undue” tax benefits, but the European Union General Court (GCEU) ultimately decided the appeal in favor of Apple and Ireland. The Starbucks state aid case involved an APA issued by the Netherlands, which Starbucks won on appeal. The Fiat state aid case, however, involved a Luxembourg ruling approving a level of payment for services rendered to it and the European Commission won its case on appeal.

2. The Procedural Aspects of State Aid Law Enforcement

Generally, the preliminary procedural steps for state aid cases depend on the type of aid involved. For “notified aid”—aid that Member States plan to grant—Article 108 of the TFEU requires all Member States to notify the European Commission. Notification of plans to grant aid triggers a preliminary investigation, but the Commission can also approve the Member State’s plans after applying the “simplified procedure.” After the preliminary investigation, the Commission either decides that there is no aid within the meaning of E.U. rules, that the aid is compatible with the internal

aid cases involving tax rulings, once the Commission found the rulings provided an advantage because they deviated from the “arm’s length principle,” a finding of selectivity followed). Ruth Mason distinguishes between tax rulings as individual aid and general aid and notes that once advantage is demonstrated in individual aid cases, a showing that the ruling did not benefit all comparable taxpayers is sufficient to demonstrate selectivity. Ruth Mason, *Special Report on State Aid – Part 3: Apple*, 154 TAX NOTES 735, 745–46 (2017). Mason further explains that in instances of tax rulings as general aid, once advantage is shown, the aid’s failure to benefit comparable firms demonstrates selectivity. Id.

243 Id.
244 See supra notes 57–78 and accompanying text.
249 TFEU, supra note 25, art. 108(3). There are three exceptions, including a de minimis exception, to the general requirement to notify the Commission of plans to grant aid. Pošćić, supra note 219, at 494.
250 Id. The simplified procedure applies to instances where the Commission must only “verify that the aid complies with “the existing rules and practice.” Id. at 495–96.
market, or that “serious doubts” remain as to the aid's compatibility with the internal market.251

The other types of aid at the initial investigatory phase are misused aid, existing aid, and unlawful aid. Misused aid is previously authorized aid252 that the Member State subsequently uses in contravention to a Commission decision.253 Existing aid is previously authorized aid that may no longer be compatible with the internal market.254 Unlawful aid is aid granted without prior Commission authorization, whether or not such aid is incompatible with the internal market.255 The Commission may initiate a preliminary investigation into existing aid256 but must initiate a preliminary investigation into unlawful aid.257 Misused aid requires a formal investigation procedure, described below.258

Following preliminary investigations, the Commission can initiate the formal investigation procedure into every kind of state aid.259 Although the Commission must initiate the formal investigation procedure for misused aid, a formal investigation into notified and unlawful aid will occur where the Commission seriously doubts that the aid is compatible with the internal market.260 The Commission will initiate the formal investigation procedure into existing aid if the Member State does not accept the Commission's proposed measures to render the existing aid compatible with the internal market.261

Following the formal investigation procedure, the Commission renders a decision with three possible outcomes.262 The Commission issues a positive decision upon determining that there is no aid within the meaning of E.U. law or that the aid is compatible with the internal market.263 The second type of decision, a conditional decision, is issued where the Commission finds the

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251 EUR. COMM’N, supra note 27, at 1 (emphasis omitted); Pošćić, supra note 219, at 495.
252 Id. at 1-2.
253 Pošćić, supra note 219, at 499.
254 EUR. COMM’N, supra note 27, at 1-2.
255 Id. at 2.
256 Id. at 1-2 (suggesting precursory steps the Commission must take before beginning a preliminary investigation procedure if the Commission wants to abolish or adapt an existing aid scheme); Pošćić, supra note 219, at 494 ("The Member States have to notify the Commission with plans to grant new or alter existing aid. However, the Commission has investigative powers and can act upon the complaint of any interested party or on its own initiative." (emphasis added)).
257 EUR. COMM’N, supra note 27, at 2.
258 See TFEU, supra note 25, art. 108(2)-(3); see also EUR. COMM’N, supra note 27, at 1.
259 EUR. COMM’N, supra note 27, at 1-2 (explaining that the Commission can open the formal investigation procedure when it finds authorized aid is being misused and must open such procedure after the Commission exhausts other investigatory steps). If the Commission seriously doubts that the aid is compatible with E.U. state aid law, it must initiate the formal investigation procedure. Id. at 1.
260 Id. at 1.
261 Id. at 2.
262 Id.
263 Id.
state measure is compatible with the internal market, but its implementation is subject to one or more conditions. The Commission issues the third type of decision, a negative decision, where the Commission finds the state measure is incompatible with the internal market and, as a result, prohibits its implementation. If the Member State has already implemented the measure, then it must recover the aid plus interest.

The Member State and the aid recipient can appeal the Commission's negative decision. The GCEU hears first appeals, and the Court of Justice of the European Union hears appeals from the GCEU. The courts are extremely deferential to the Commission's economic assessments and primarily inquire into whether the Commission's conclusions are sufficiently reasoned, the material facts are accurate, and the Commission complied with the procedural rules. If the E.U. courts uphold the Commission's negative decision, some issues, such as the precise amount of aid recoverable, can still be litigated in the Member State's courts.

**B. The Structure of a BEPS-Focused Disgorgement Mechanism**

The previous discussion outlined the substantive and procedural aspects of E.U. state aid law and will be helpful in understanding the similar structure of the proposed BEPS-focused disgorgement mechanism. The two should look procedurally similar, but substantively different because state aid law is not adequately equipped to handle BEPS issues.

1. The Inadequacy of State Aid Law to Combat BEPS Issues

E.U. state aid law is an imperfect body of law in the BEPS context. There may be some overlap between state aid and the subject matter of tax rulings of which the OECD BEPS Project’s Action 5 mandates exchange. For example, some commentators have suggested that state aid can sufficiently cover rulings.

264 *Id.*; *see also* Polčić, supra note 219, at 497 (“The Commission may attach to a positive decision conditions and may lay down obligations to allow compliance with the decision (‘conditional decision’”).

265 *EUR. COMM’N, supra note 27, at 2.

266 *Id.* An exception exists when such a recovery would be “contrary to a general principle of EU law.” *Id.*

267 *See id.* (“All decisions and procedural conduct of the Commission are subject to review by the General Court and ultimately by the ECJ.”). If the Commission renders a positive decision, the aid recipient’s competitors can appeal the Commission decision. *See Mason, supra note 240, at 948.*

268 *EUR. COMM’N, supra note 27, at 2.


270 *Id.* at 949.
pertaining to harmful preferential tax regimes, as state aid covers income from a larger set of activities than that of harmful preferential regimes. But in general, state aid law would not encompass all tax rulings that deviate from the OECD BEPS Project Actions and OECD standards, which the BEPS-focused disgorgement mechanism would necessarily regulate.

State aid cannot adequately combat BEPS issues because tax rulings arguably do not provide a benefit through state resources. As mentioned above, a finding of violative aid requires, in part, a finding that the Member State used state resources to grant the contested measure. In tax-related state aid cases, GCEU and Commission decisions find that reducing the aid recipient’s tax liability below the amount that would seemingly result from a normal application of the Member State’s tax laws constitutes a use of state resources. In negative decisions, the Commission typically offers little more than conclusory language that the Member State would have raised more tax revenue had it not issued the contested ruling. For example, in a state aid decision involving a tax ruling granted by Luxembourg to the French company Engie, the Commission noted “the tax treatment granted on the basis of the contested tax rulings can be said to reduce the corporate income tax liability in Luxembourg of the Engie group and therefore gives rise to a loss of State resources.” Importantly, as two commentators note, the comparison between the tax revenue the Member State raised and the tax revenue that it would have raised if there was no ruling implicitly

271 See, e.g., Faulhaber, supra note 34, at 338 (“[T]he state aid prohibition continues to define harmful tax competition more broadly than the FHTP . . . .”).

272 Compare OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, at 19 (“To be [a harmful preferential regime], the regime must, firstly, apply to income from geographically mobile activities, such as financial and other service activities . . . .” (emphasis added)), with TFEU, supra note 25, art. 107(1)(a) (defining state aid, in part, as “any aid . . . favouring certain undertakings or the production of certain goods”); see also Faulhaber, supra note 34, at 331-32 (noting that the state prohibits “using essentially any tax tool . . . designed to attract everything from revenue and legal ownership to the location of corporate headquarters and even employment and other activities”).

273 The actual resolution of some recent tax ruling-related state aid cases also produces doubt as to state aid law’s effectiveness in this area. See, e.g., Case T-892/16, Apple Sales Int’l v. Comm’n, ECLI:EU:T:2020:338, ¶ 507 (July 15, 2020) (finding that tax authorities had not granted a selective advantage by issuing tax rulings); Case T-636/16, Starbucks Corp. v. Comm’n, ECLI:EU:T:2019:669, ¶ 561 (Sept. 24, 2019) (finding that the Commission failed to show a selective advantage).

274 See supra notes 226–30 and accompanying text.

275 See, e.g., Case C-387/92, Banco Exterior de España SA v. Ayuntamiento de Valencia, ECLI:EU:C:1994:100, ¶¶ 13-14 (“[T]he concept of aid . . . embraces . . . interventions which, in various forms, mitigate the charges which are normally included in the budget of an undertaking . . . . It follows that a measure by which the public authorities grant to certain undertakings a tax exemption . . . constitutes State aid . . . .”).

contemplates the following counterfactual: what would the ruling recipient’s tax liability have been had the Member State not issued the ruling? If indeed finding that a measure uses state resources implicitly involves this counterfactual, then the Commission’s negative decisions are misguided. In finding that a selective advantage in tax ruling cases necessarily entails the use of state resources, the Commission effectively compares the ruling recipient’s tax liability to what it would have been absent the ruling holding everything else constant. However, the proper application of the counterfactual should account for all the behavioral implications had the country not issued a ruling, rather than artificially limiting the contemplated changes to the tax revenue raised. Specifically, the Commission and E.U. courts should determine whether the recipient of the contested aid would have actually shifted its income if the country at issue had not issued the ruling.

In many cases, considering the full range of behavioral implications for the absence of a ruling supports the proposition that the ruling never truly involved a use of state resources. As demonstrated, rulings are often the only means by which a country can induce an MNE to shift its income to the issuing country. In such cases, absent a ruling, the MNE would not have shifted its income to the country in question. Without the income shifting, the country in question would not have raised any tax revenue. With the income shifting, the country at issue does raise tax revenue. Therefore, the ruling actually increases the Member State’s revenues, directly contradicting the conclusion that the ruling constituted a use of state resources. Thus, state

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277 See Giraud & Petit, supra note 29, at 236 (“Here, the Commission proposes to verify whether, in the case at hand, the level of taxes raised by the concerned Member State was lower than it would have otherwise been absent the measure.”).

278 See id. at 235-36 (concluding that when determining the use of state resources, “the Commission refers to the section of its decision dedicated to the selective advantage, thus suggesting that the existence of an advantage necessarily entails the use of State resources”); see, e.g., id. at 235 n.14; Commission Decision 2019/1421, supra note 276, at 28-29 ¶¶ 153-162 (implying a deviation from the normal tax system is sufficient for a finding of both selective advantage and the use of state resources); Commission Decision 2017/1283, supra note 13, at 53-54 ¶¶ 157-62 (using a deviation from Ireland’s normal tax system as support for a finding of both selective advantage and the use of state resources); Commission Decision 2016/2326 of 21 Oct. 2015 on State Aid SA-38375 (2014/C ex 2014/NN) Which Luxembourg Granted to Fiat, 2016 O.J. (L 351) 1, 34 ¶ 188-90 (noting that because the ruling at issue reduced the Fiat group’s lower tax liability below the level mandated by the Luxembourg tax system, Luxembourg provided both a selective advantage and used state resources); Commission Decision 2017/502 of 21 Oct. 2015 on State Aid SA/38374 (2014/C ex 2014/NN) Implemented by the Netherlands to Starbucks, 2017 O.J. (L 83) 38 ¶¶ 225-28, 78-79 (justifying a finding of both selective advantage and the use of state resources because a tax ruling enabled the recipient to pay less tax than a normal application of the Netherlands’ tax system would impose).

279 In some cases, at best, it is ambiguous whether the ruling involved the use of state resources. See Giraud & Petit, supra note 29, at 236 (“[T]he Commission takes for granted that, absent the ruling, the revenues of the beneficiary in question would have been the same.”).

280 See id. (“[S]ince the beneficiary had the possibility to locate its revenues elsewhere, it would probably have done so absent a ruling on satisfactory terms.”).
aid law is not only inadequate to handle tax rulings that offer small tax concessions, but it cannot even combat the most egregious tax ruling uses because such rulings are prima facie more indicative that the ruling was necessary to induce the MNE’s income shifting. Therefore, violative tax rulings, insofar as they violate OECD guidelines and give rise to BEPS concerns, do not violate state aid law, and, as such, state aid law cannot adequately combat the use of rulings to induce income shifting.

2. The Specifics

Because substantive state aid law cannot adequately address BEPS issues, it cannot provide the substantive backdrop to a BEPS-focused disgorgement mechanism. Rather, the substantive backdrop of the mechanism should be derived from three sources: OECD BEPS Project Actions, other OECD guidance, and the substantive tax law of the country at issue. Generally, other Actions and OECD work, such as the OECD Transfer Pricing Guidelines, address the various subject matter underlying tax rulings within Action 5’s scope. As such, the OECD has already effectively established the substantive guidelines for a BEPS-focused disgorgement mechanism through its minimum standards and best practices pertaining to the subject matter of rulings within Action 5’s scope. These standards are the ideal source of substantive standards for the proposed disgorgement mechanism because their purpose is to counter BEPS issues, and a finding that ruling subject matter violates them does not involve the challenges associated with findings of state aid law violations.

Notwithstanding the benefits of the OECD BEPS Project’s Actions and other OECD guidance, the substantive backdrop should also include, to the extent consistent with such Actions and other guidance, the issuing country’s tax laws. Rulings that do not comply with an issuing country’s tax laws can induce artificial income shifting. Moreover, the OECD readily admits that notwithstanding the OECD BEPS Project Actions, there is still significant

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281 See OECD, OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (2017), for more information on the OECD’s Transfer Pricing Guidelines.

282 Action 5 subjects six types of rulings to exchange. Action 5 provides the standards for preferential regimes and the FHTP’s authority to identify rulings that could give rise to BEPS issues. See generally OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 91. The OECD Transfer Pricing Guidelines set standards for APAs. See id. ¶¶ 99-100 (using the OECD Transfer Pricing Guidelines to explain APAs in the context of Action 5’s transparency framework). Action 7 provides permanent establishment standards. See generally OECD, ACTION 7 – 2015 FINAL REPORT, supra note 134, at 9. However, related party conduit rulings and rulings related to downward adjustments of taxable profits are not contemplated by any specific Action item, but rather implicitly can give rise to BEPS issues as both types of rulings can induce income shifting.
artificial income shifting that occurs.283 As such, it is possible that the issuing country’s tax laws may address issues that the OECD BEPS Project’s Actions and other OECD guidance do not adequately deal with. In this way, the issuing country’s tax laws may act as a second layer of defense against ruling-induced artificial income shifting. Additionally, countries should generally apply their tax laws, like all other types of law, consistently.284 This substantive background would ensure consistent application of tax law even if a ruling deviates from the issuing country’s tax laws but does not conflict with the different Actions or other OECD guidance.

The procedural and other non-substantive aspects of the disgorgement mechanism should mirror those of E.U. state aid law. To that end, the BEPS-focused disgorgement mechanism first needs an enforcement arm analogous to the European Commission. The FHTP is well positioned to assume this role. Action 5 specifically tasks the FHTP with annually reviewing the spontaneous exchange of tax rulings mandated by the OECD BEPS Project.285 Specifically, the FHTP analyzes the effectiveness of participating countries’ exchanges and the scope of the rulings covered.286 In addition, tax rulings subject to Action 5’s mandated exchange include those that the FHTP itself determines could give rise to BEPS issues if there were no exchange.287 The FHTP must therefore necessarily be attuned to identifying and addressing ruling practices that implicate the very motivation of the OECD BEPS Project: preventing artificial income shifting and tax avoidance. Therefore, the FHTP has the requisite expertise to assess rulings and identify those that violate the underlying substantive subject matter that subjects the ruling to Action 5’s transparency framework.

In addition to an enforcement arm, there also needs to be an analog to the GCEU for appellate purposes. The mutual agreement procedure (MAP) is a possible body that can be tasked with hearing appeals of FHTP decisions. MAP is the primary mechanism by which countries can resolve disputes about the proper interpretation and application of the provisions in tax treaties between them.288 Action 14 bolstered MAP by providing for more

283 See Fresh Insights, supra note 21 (providing data on profit shifting and noting the continued prevalence of BEPS strategies); see also Finley, supra note 21, at 268 (stating that the data suggest that the OECD BEPS Project has not yet achieved its goal).
284 See generally LON L. FULLER, THE MORALITY OF LAW 59-60 (rev. ed. 1964) (discussing the just application of tax laws); see also Yoav Dotan, Making Consistency Consistent, 57 ADMIN. L. REV. 995, 1001 (2005) (“Consistency is undoubtedly a concept of paramount importance within any legal system.”).
285 OECD, ACTION 5 – 2015 FINAL REPORT, supra note 17, ¶ 153.
286 Id.
287 Id. ¶ 91.
efficient and consistent decisionmaking. Also, some countries have committed to treating MAP decisions as binding on them.

However, because MAP primarily handles tax treaty disputes, it may not be adequately equipped to handle all the BEPS issues associated with tax rulings. Tax treaty discrepancies, especially as they pertain to residence and PE criteria, facilitate tax motivated artificial income shifting. The OECD acknowledges that while the purpose of treaties is to prevent double taxation, treaties sometimes “allow[] income from cross-border activities to go untaxed.” More specifically, MNEs utilize treaty discrepancies to create “double non-taxation, in particular through the use of conduit companies.” Action 6 of the OECD BEPS Project directly addresses tax treaty abuse and the resultant BEPS issues associated with “treaty shopping.” Regardless, BEPS issues in general, and those selectively identified in Action 5’s transparency framework, consist of more than mere utilization of tax treaty discrepancies. As such, MAP may not possess expertise in general BEPS issues comparable to that of the FHTP. Therefore, the OECD should incorporate into MAP a distinct subdivision with expertise in BEPS matters comparable to that of the FHTP.

While the FHTP and MAP apply the disgorgement mechanism’s substantive standards to issued rulings, the issuing country should be responsible for collecting the unwarranted tax concessions afforded by the ruling, as happens under current state aid law enforcement. But because the OECD BEPS Project is soft law, participating countries will need to enact domestic legislation to enforce FHPT and appellate decisions. Domestic legislation is the primary means by which participating countries commit themselves to the OECD BEPS Project. Domestic legislation mandating the collection of unwarranted tax concessions will ensure that the mechanism creates the desired behavioral changes.

289 See id.
290 These countries are Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom, and the United States. Id. at 10.
292 Id. at 3.
C. Reasons for the Adherence to the BEPS-Focused Disgorgement Mechanism

Thus far, this Comment has argued that a disgorgement mechanism is necessary to achieve the desired effects of Action 5’s tax ruling transparency framework and has proffered a general structure this mechanism can take. However, this proposal is effective only to the extent that the relevant countries—those that issue violative tax rulings notwithstanding their agreement to comply with the OECD BEPS Project’s Actions—participate. Adherence to a BEPS-focused disgorgement mechanism would be a large commitment for those countries that issue violative rulings. Committing to the prospect of disgorgement is contrary to these countries’ incentives identified earlier, which is primarily to induce income shifting to extract a sliver of otherwise unobtainable tax revenue. Adherence to a BEPS-focused disgorgement mechanism would eliminate a tool these countries use to extract this tax revenue. From the perspective of these countries, adherence to a disgorgement mechanism appears to be directly at odds with their current incentives. Accordingly, adherence at first appears to be a rather lofty goal.

However, if adherence can create net benefits that exceed the net benefits of issuing tax rulings that induce income shifting, then adherence is not only possible, but in these countries’ best interest. As mentioned, because the OECD BEPS Project is soft law, a country’s deviation from its terms does not impose any material adverse reputational impact to the country at issue. This does not necessarily mean that the converse is true. In fact, adherence to soft law agreements may actually create a material and beneficial reputational impact to that country. Compliance with international agreements generally enhances a country’s reputation for being collaborative and committing, and this reputational effect is in some cases a reason for entering into international agreements. Because adherence to a BEPS-focused disgorgement mechanism would signal a strong commitment to stemming tax avoidance, the reputational benefits from such adherence would likely be large. Accordingly, to the extent the benefits of committing to a BEPS-focused disgorgement mechanism exceed the net benefits of continuing to issue violative tax rulings, committing is in those countries’ best

295 See supra Section II.A.
296 See supra notes 193–94 and accompanying text.
297 See Christopher A. Whytock, Thinking Beyond the Domestic-International Divide: Toward a Unified Concept of Public Law, 36 GEO. J. INT’L L. 155, 172 (2004) (noting that compliance with international law enhances a country’s reputation for “law-abidingness” and thus makes them “a more attractive partner” to other governments).
298 See, e.g., European Parliament Decision on Resolutions of the Fourth International Parliamentary Conference on the Environment in Kingston, in 3 ENV’T POL’Y & L. 95, 96 ¶ 15 (1977) (“[A]ctive participation by the [European] Communities in the drawing up of international agreements on the protection of the environment can only serve to enhance their reputation in the world.”).
interest. Therefore, the BEPS-focused disgorgement mechanism may be able to garner widespread adherence.

**CONCLUSION**

The OECD BEPS Project is commendable because it addressed many facets of tax systems that give rise to BEPS issues. However, although the OECD BEPS Project provided comprehensive substantive measures for participating countries to implement, tax rulings, in theory, still remain an extremely viable mechanism to induce income shifting because they allow for selective deviations from any given country's tax laws and OECD guidelines.

Tax ruling transparency alone is an inadequate method to combat this abuse. The support for tax ruling transparency relies on the proposition that enhanced disclosure will disincentivize the use of rulings to selectively decrease MNE tax liability. This necessarily assumes that transparency will decrease rulings' net benefits to either countries or recipient MNEs. However, transparency alone fails to do so.

Therefore, introducing a BEPS-focused disgorgement mechanism is the best way to address the abuse of tax rulings. With disgorgement, there is a chance that the recipient MNE will have to remit the tax concession afforded through the ruling. Once coupled with Action 5's transparency framework, there will be an increase in the number of instances in which using rulings to grant tax concessions is no longer viable. Once no longer viable, countries and MNEs can no longer use rulings to facilitate tax avoidance.

Introducing a BEPS-focused disgorgement mechanism would be a significant feat. It would require a commitment from all participating countries and necessarily involve partial remittance of countries' discretion of their power to tax. But the mechanism's introduction is not too far removed from countries' current commitment to the OECD BEPS Project. The mechanism would merely enforce the standards to which these countries already committed. And adherence to such a mechanism may provide significant reputational benefits that exceed the net benefits from using tax rulings to induce income shifting. Therefore, a BEPS-focused disgorgement mechanism may be attainable.