Shifting European real estate profits to zero taxation

The role of Luxembourg

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Executive Summary

Tenants in many European countries, especially in the biggest cities are suffering from exploding prices for housing and rent. These price explosions are partly driven by professional investors from the global financial markets that discovered residential real estate as a lucrative investment. Many of them channel their profits from European real estate out of the EU virtually untaxed. To do so they often use intra-group interest payments routed via Luxembourg. Despite the exposure of such structures in the LuxLeaks and the Paradise Papers and various reform efforts such as the EU's anti-tax avoidance directives these structures still exist. Just like the big digital companies the real estate investors combine big profits with minimal tax. Therefore national as well as international efforts against profit shifting and tax avoidance should not stop until they are properly taxed as well.

Based on the analysis of financial accounts of selected international real estate investments from Berlin and other European countries, the study finds that profit shifting via intra-group interest payments is still widely used. A detailed analysis of investors in Berlin shows that Luxembourg is not the only but by far the most common conduit country for real estate investment funds investing there and in Europe. Tax avoidance structures in Luxembourg are used by big private equity companies from the US like Blackstone as well as wealthy families such as the Pears brothers from the UK. While raising capital for as little as 0.5% on the global financial market, the companies analyzed for this study charge themselves interest rates of up to 7.64% for their intra-group financing. By doing so, they manage to shift up to half of their rental income out of the countries where the real estate is located to Luxembourg, often even creating losses that can be offset against potential future capital gains from the sale of the assets. As a result they pay hardly any tax in the country where the real estate is located. The permissive interpretation of tax law in Luxembourg and instruments like profit participating loans allow them to channel these intra-company payments further into countries and vehicles were no or hardly any tax is levied, such as Jersey or the Cayman Islands. By using hybrid structures and by allowing complete anonymity they finally ensure that the final (usually very wealthy) investors pay less tax then normal employees in their home countries or even evade taxes and scrutiny completely.

To stop this tax-injustice, Germany - and other source countries in the EU - should take unilateral measures to effectively counter the abuse of existing transfer pricing rules. Measures already in place in some European countries might be a good starting point. France, for example, uses an upper-limit for intra-group financing based on average market rates and shifts the burden of justification for any higher rate onto the companies. Denmark levies a withholding tax on intra-group interest payments, and Belgium has a dedicated anti-abuse law aimed at the fund industry (so-called Cayman tax). The European Commission, in its 2019 semester report, recognizes that "*Luxembourg's tax rules are used by companies that engage in aggressive tax planning*" but has failed so far to effectively change this situation. Unilateral measures by member states are often contested at the European level with recourse to various EU directives and basic freedoms. A recent judgement by the European Court of Justice in favor of Denmark, trying to enforce its withholding tax against abusive structures using, among others, intra-group interest payments routed via Luxembourg, is encouraging. But if the rather wide interpretation of the space for anti-abuse measures by the judges in this case should not hold more broadly, the EU might have to change the contested directives. Finally both EU member states and the EU should work to reach a global agreement on an effective minimum tax that includes the investment business, and if such agreement cannot be reached, implement corresponding rules at the EU-level or plurilaterally in the framework of enhanced cooperation.

Table of Contents

Table of Contents

Executive Summary 1
Table of Contents 2
The problem 3
Stage 1 – Getting profits out of the country where they are earned 4
Stage 2 - Channeling profits virtually untaxed through Luxembourg 6
Stage 3 – Avoiding taxation in the destination country 7
Summary of a typical tax avoidance structure 8
Real-world examples 9
Blackstone 9
Pears 10
Other residential real estate investors in Berlin 11
Possible Solutions 12
Stage 1 – Germany (or other European source countries) 12
Stage 2 – Luxembourg and EU 14
Stage 3 – Globally 17
Conclusion 18

The problem

*„**Tax neutrality is an essential feature of investment funds:** From a tax perspective, the tax treatment of investment funds is designed to preserve the tax neutrality of investments made through investment funds compared to a direct investment […] It is however important to bear in mind that taxation arises at all (other) levels in an investment fund structure i.e.*

- *through withholding taxes applied at source on certain type of income received by the fund;*
- *in the hands of investors in the fund on income received or gain realized in accordance with the tax rules applicable in their country of residence. Exchange of information mechanisms put in place, such as the Common Reporting Standard, have ensured that income and capital gains are effectively taxed in the hands of investors by the relevant States."*

--- ALFI – Association of the Luxembourg Fund Industry, 12 November 2019

In 2012 people were protesting in front of coffee shops throughout the UK against Starbucks shifting its profits out of the UK where they were earned to tax havens where they would not be taxed.[1] Two years later the LuxLeaks exposed how Luxembourg had helped numerous companies – among them many real estate investment firms – to minimize their tax payments.[2] As a reaction, the OECD created an initiative on Base Erosion and Profit Shifting ("BEPS") and published several thousands of pages of recommendations summarized in 15 action points in 2015. Some of the proposed solutions have been or are being implemented in the EU and in Luxembourg through ATAD 1 and ATAD 2.

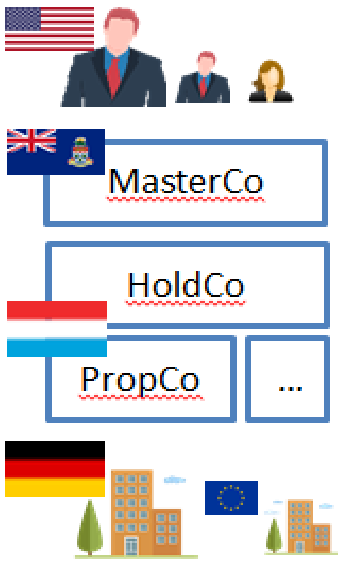
At the time of the OECD discussions leading to the 2015 recommendations, intra-company finance was one of the most commonly used profit shifting tools and according to the OECD "*one of the most simple*".[3] Action 4 proposed several solutions and several countries implemented rules to limit interest deductions based on a solution pioneered by Germany in 2007 (so-called "Zinsschranke"). Despite these initiatives, investment funds, private equity firms and other investors continue to shift profits earned from real estate throughout Europe to places with 0% corporate tax rates like Jersey or the Cayman Islands using intra-company loans, mostly via Luxembourg. This is all the more remarkable, because real estate and intra-company finance for real estate transactions are the direct opposite of hard-to-tax digital business models. Hoping for the home countries of the investors to ultimately tax the income appropriately – like the Association of the Luxembourg Fund Industry suggests – is no satisfactory solution either. TJN (2015) outlines ten reasons why corporation tax is an important element of tax justice and a study for the EFA/Greens in the European Parliament (2019) shows that taxation of investment income often remains wishful thinking thanks to special tricks and outright tax evasion.

This study uses an illustrative example to explain how shifting profits through intra-company loans can continue to date. Furthermore, the analysis of financial accounts of selected international real estate investments from Berlin and other European countries shows that these structures are still widely used. They usually involve at least three steps, namely 1) artificially inflated interest rates not

[1] See for example: https://www.theguardian.com/business/2012/dec/08/starbucks-uk-stores-protests-tax
[2] For an overview of related stories see: https://www.icij.org/investigations/luxembourg-leaks/, for examples of the structures in use see: https://www.theguardian.com/business/gallery/2014/nov/07/12-luxleaks-diagrams-that-will-make-your-head-spin, for a timeline of events from the emergence of tax rulings in 1997 to the political reactions after the leak until 2016 see: https://sven-giegold.de/luxleaks-tax-rulings-chronology-events/
[3] http://www.oecd.org/tax/beps/beps-actions/action4/ According to Overesch (2016) they were responsible for around one third of artificial profit shifting

denied by local tax agencies and dysfunctional limits on interest deductions in the source country 2) permissive regimes of transfer pricing rules, agreements and absence of functioning taxation at source in the transition country 3) low or no taxation of corporate and personal income in the jurisdictions of the investment entities thanks to hybrid structures, local tax exemptions or anonymity facilitating outright evasion.

Our illustrative example follows these three steps using three different corporate entities:



1. The entity that owns a house in Berlin, Germany but is registered in Luxembourg. For example Berlin Property 1 S.a.r.l (or “PropCo”);
2. The second Luxembourg entity that holds the shares in the PropCo, that could be called Berlin Holding S.a.r.l (or “HoldCo”);
3. The entity from a zero-tax jurisdiction, let’s say British Virgin Islands, that channels the profits out of Europe, the Berlin Master Limited (or “MasterCo”) and allows investors to optimize or even evade their taxation at home.

Reality is often a bit more complex and there is a considerable variety of arrangements and jurisdictions used but the principle remains the same.
Disclaimer: Most investment funds use normal corporate structures such as partnerships and limited liability companies but sometimes special tax rules apply to them – like for example the German investment tax law (“Investmentsteuergesetz”). To analyze these rules in detail goes beyond the scope of this study but the basic structure described here is not affected by the special tax rules. Germany has recently changed its investment tax law making most investment fund structures liable to normal corporate tax at least in theory. Extending the applicability of anti-avoidance rules for corporations to investment funds is currently under discussion. One of the few European countries with a dedicated anti-abuse legislation for investment funds is Belgium with its so-called “Cayman Tax”.[4]

Stage 1 – Getting profits out of the country where they are earned

No matter where the PropCo of our example is registered – be it Germany, Luxembourg or any other place in the world – it will usually have to declare its income and pay related taxes in the place where the real estate is located. That’s because income from real estate – both the operational surplus from rent and the gains in value - is special. The OECD Model Tax Convention, the UN’s equivalent as well as (nearly) all bilateral double-tax agreements, grant the taxing right for real estate income to the country where the real estate is located. In our example the PropCo is registered in Luxembourg. Like that, thanks to a historically grown quirk in German tax law, it will only pay 15.75% of tax on any profit it makes (for more information see Box 1). That’s much less than the 30% that are usually due but still too much for the typical investment fund manager. That’s where intra-group interest payments come in.

[4] For more details see: https://www.bakermckenzie.com/en/insight/publications/2019/05/belgian-cayman-tax

Box 1 – A German tax exemption for wealthy investors

Corporate tax in Germany usually consists of three parts a) the corporate tax proper ("Körperschaftssteuer") of 15% b) a surcharge of 0.75% to finance reunification costs ("Soli") and c) the local business tax ("Gewerbesteuer") varying depending on the place between 7.5 and 22%. The local business tax is charged at the main place of operations and split between localities based on where the company's employees are. Any company limited to managing real assets and without further commercial activity can claim relief ("erweiterte Kürzung") – a tax exemption instated in 1936 to promote investment, upheld in court in 2010 and defended by the government as recently as 2016.[5] This results in three possible ways of avoiding this tax, all rather frequent in real estate investment.

1. If you are commercially active in Germany, because you frequently trade apartments or you are actively developing your property, then your best bet is to move operations to a place where local business tax is low. Around any big German city you'll be likely to find a well-connected, small town, offering the minimum tax of 7.5% or something very close - like Zossen and Schönefeld just south of Berlin, Grünwald close to Munich, Monheim close to Düsseldorf or Eschborn for Frankfurt.[6]
2. If you just want to manage your real estate wealth and enjoy the rent flowing in without commercial activity but still want to stay in Germany you can apply for a relief from local business tax ("erweiterte Kürzung"), with the risk of losing it due to any small commercial activity that you might be found to be doing.
3. The safest bet to not pay any local business tax is to register outside Germany (for example in Luxembourg) and make sure there are no managers or activity in Germany constituting a German permanent establishment – for example by outsourcing local functions to a local management company.

Let's assume then that our PropCo is registered in Luxembourg and owns 100 apartments worth €20 million with annual rent income of €1 million. Let's assume further that after deducting maintenance and management costs, depreciation and interest payments for the loan at the local bank it makes an annual taxable profit of €250.000. Without profit shifting, it would now have to pay approximately €40.000 of tax every year. To avoid that, the HoldCo provides a loan of €10 million at an interest rate of 5% and claims interest payments of €500.000 each year. Instead of a taxable profit, the PropCo now makes a loss that it can carry forward until it decides to sell off individual apartments to avoid paying tax on the capital gain that are taxed once they are realized.

In theory, source countries (such as Germany in our example) have several options to fight profit shifting via such intra-company loans. According to internationally-agreed tax rules, they could challenge the so-called transfer pricing concept underlying the transaction. This means they could show that interest rates charged are not in line with market conditions for comparable loans made

[5] The "erweiterte Kürzung" (§ 9 Nr. 1 Satz 2 GewStG) was introduced in 1936. There is no exact data on the costs of this tax exemption but the answer to a parliamentary question of the Greens from 15th of November.2016 puts the costs at approximately one billion Euros with about 10,000 companies benefitting. According to the answer, the government saw no reason to change this exemption.

[6] For more details check the German country report for the Financial Secrecy Index 2020 (https://fsi.taxjustice.net/PDF/Germany.pdf). For a detailed story of Berlin real estate investors hiding in one of them see: https://www.berliner-zeitung.de/wirtschaft-verantwortung/der-geheime-eigentuemer-li.79219 (in German).

between independent parties (the so-called arms-length principle). Secondly some countries, including Germany, limit the amount of interest that can be deducted from taxable profits in general (so-called “Zinsschranke”). And thirdly they can introduce withholding taxes. We look at each of these solutions in chapter 3 and show that none of these tools seem to be widely and successfully used in Germany or throughout Europe, but that there are some notable differences between different source countries. For the moment, let’s continue our example.

Stage 2 - Channeling profits virtually untaxed through Luxembourg

“*Economic evidence suggests that Luxembourg's tax rules are used by companies that engage in aggressive tax planning. […] Due to the absence or possible exemption of withholding taxes, outbound payments of dividends, interest, and royalties from Luxembourg-based companies to non-EU jurisdictions could lead to little or no taxation if these payments are not taxed or taxed at a low level in the recipient jurisdiction. […]The level of capital flows (dividends, interest, but also royalties) is also among the highest in the EU, and at a high level compared to the size of the economy..”* European Commission, European Semester report, 26.2.2020

At the level of the HoldCo – in our example a second company registered in Luxembourg - the interest payments from the PropCo arrive as income. If this was taxable income and depending on the company’s size and location, Luxembourg would charge an average of 26% of corporate tax[7] and even has a wealth tax on corporate assets. To avoid these taxes, the HoldCo uses a so-called back-to-back loan with the MasterCo. This means that (nearly) all the interest income the HoldCo receives from the PropCo immediately leaves the HoldCo as interest payments for the loan it received from the MasterCo. For this simple trick to work, several requirements will have to be fulfilled:

1. The local tax agencies have to be convinced that the interest payments taking all the profit out of the HoldCo are not to be qualified as hidden profit distributions or dividends, because otherwise they would no longer be deductible from the HoldCo’s profit and would therefore be liable to corporate taxation and potentially a withholding tax on dividends;
2. The German tax agencies (and the European courts) have to be convinced that the HoldCo is not a mere conduit, incorporated just to avoid taxes.

Luxembourg is not the only (European) country that continues to allow such tricks to work, but there’s ample evidence how Luxembourg facilitates these kinds of structures and both the macroeconomic statistics and our real-world examples presented in chapter 2 show that such tricks continue to happen in Luxembourg on a large scale.

Box 2 – Luxembourg as a tax haven

In 2014, the LuxLeaks exposed various structures that allowed income from European (real estate) investments being channeled virtually tax free through Luxembourg. Often within few hours or days of the request being made, the Luxembourg tax agencies widely granted so-called advance tax agreements ensuring the taxpayers that none of the profits channeled out of Luxembourg would be reclassified as dividend and therefore liable to tax in Luxembourg.[8] The structures described in these

[7] Like Germany, Luxembourg also has a local business tax with differing rates. The average was taken from: https://www.bundesfinanzministerium.de/Monatsberichte/2019/08/Inhalte/Kapitel-3-Analysen/3-2-wichtigste-steuern-im-internationalen-vergleich.html (in German)

[8] The Luxembourg income tax law does not define precisely which instruments should be considered as debt or equity. The classification of a financial instrument towards an equity or debt pattern is based on an economic

agreements – and still widely used - included Income Participating Loans (IPLs) or Profit Participating Loans (PPLs).

A publication of the IMF (2019) demonstrated that Luxembourg with its population of 600,000 received foreign investments of US$4 trillion, 10% of the global total, equaling the receipts of the United States and by far outshining China as an investment destination. But it argued that most of that investment was phantom investment just flowing through the country to other places.[9] Intra-group interest payments making profits flow through Luxembourg are just one of several different ways of using Luxembourg for tax avoidance. A study by the Greens/EFA (2019b) that found effective tax rates of just 2.2% in Luxembourg points to other structures were profits – unlike in the case of intra-group tax payments - actually accrue in Luxembourg but are not taxed (i.e. as dividends or investment fund income).

A study on aggressive tax planning indicators for the European Commission (2018) also showed the extreme shares of foreign direct investments compared to GDP in Luxembourg (5766% inward, 6749% outward compared to a European average of 63,1% and 72,9% respectively) as well as the big role of special purpose entities and the high share of foreign-owned firms (49,1% of turnover compared to an average of 28,3%). The 2020 semester report for Luxembourg shows that between 2013 and 2017 Luxembourg had the highest total amount of outgoing interest payments and the biggest share going to OFCs (€10 billion) and continues to ask for concrete reforms to address aggressive tax planning in particular by means of outbound payments.

Continuing with our example, to shift virtually all profits out of Luxembourg untaxed, the MasterCo agrees on a profit participating loan (or any similar vehicle) with a fixed interest rate of 1% and a variable interest rate depending on the profit of the HoldCo. The HoldCo in turn passes on (nearly) all the profits to the MasterCo. To satisfy the German tax agency, European courts and international corporate tax rules, the HoldCo institutes some local management function in Luxembourg and keeps a small margin of 0.1% of the loan (i.e. €10.000 per year) as a "fair" compensation for the "risk" it is taking and pays tax on it in Luxembourg. [10]

Stage 3 – Avoiding taxation in the destination country

To achieve complete non-taxation or tax neutrality – as the Luxembourg Fund Industry would call it – taxes finally have to be avoided at the level of the MasterCo. This can be achieved by placing the MasterCo in a zero-tax jurisdiction (like Jersey, the Cayman Islands or the British Virgin Islands) or by using tax-exempt vehicles such as charitable institutions, state-run pension funds or Luxembourg investment funds that only pay a small tax on net assets and no corporate income tax. Another option is to use hybrid structures (see box 3).

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analysis of the terms and conditions of the contract. According to an expert consulted for this study, features like (i) maturity below 30 years, presence of a fixed remuneration, seniority and absence of conversion and stapling features are generally sufficient to define a financial instrument as a debt contract.

[9] Another paper by the European Commission (2018) shows the exceptionally high share of FDI compared to GDP in Luxembourg (p.72) and the role of SPEs (p.65): https://ec.europa.eu/taxation_customs/sites/taxation/files/taxation_papers_71_atp_.pdf

[10] Article 56 and 56*bis* of the Luxembourg income tax law (Loi modifiée du 4 décembre 1967) - http://www.impotsdirects.public.lu/content/dam/acd/fr/legislation/LIR/LIR2017.pdf, complemented by the Circular 56/56*bis* issued by the Luxembourg tax authorities on 27 December 2016.

Box 3 – The best of both worlds, a hybrid investment scheme US/Luxembourg

With private insurance and sophisticated financial markets as well as high and highly concentrated wealth, the US is the main source of global investment finance. At the same time it has arcane tax rules that give rise to special avoidance structures. In particular, the US check-the-box rule[11] allows investors to choose whether they'd like a business entity to be treated as a corporation or a transparent entity, i.e. an entity that is disregarded for US tax purposes. Consequently, the Cayman Islands, the preferred conduit country for US investors, is constantly developing new legal structures such as the Exempted Limited Partnership (2014) or the Cayman LLC (2016) that allow to make creative use of differing tax qualifications in different countries. Luxembourg also offers so-called Convertible Preferred Equity Certificates (CPECs) or Preferred Equity Certificates (PECs). When structured correctly these Certificates might create so-called "hybrid" payments that are qualified as interest by the Luxembourg tax agencies (and therefore tax-deductible and free of withholding tax) but at the same time qualified as dividends by the US tax agencies and therefore tax-free until finally distributed.[12]

For the sake of simplicity, let's assume that the MasterCo in our example is a limited company from the British Virgin Islands. As such, any profit it makes from the excessively high interest payments it receives from Luxembourg will be taxed at 0%. And it will most likely stay completely untaxed until the owner(s) decide to distribute the profits and declare them in their income tax declaration in the respective home countries. As a previous study for the EFA/Greens (2019a) has shown, despite recent progress, there are still many legal ways for wealthy European individuals to postpone, avoid or reduce the taxation of its investments throughout Europe and globally. An investor benefitting from the non-dom status in the UK or comparable rules in Portugal, Malta or Cyprus might not have to pay any tax as long as he doesn't transfer the money to an account in his home country or uses it there, while for tax refugees Italy would only charge an annual lump sum payment of €100.000 independent of the foreign earnings. Furthermore, according to Zucman's estimates (2015) Luxembourg hosted more than 20% of global anonymous and missing wealth in 2013, most of it most likely undeclared and evading tax at home.

Summary of a typical tax avoidance structure

Table 1 summarizes the case example. In essence, the property is held by a Luxembourg company (the PropCo) that is liable to 15.75% of tax in Germany on its profits. But this company wipes out all its profits with intra-group interest payments to a Luxembourg holding company (the HoldCo) and even manages to build some losses for potential profits from future sales. The HoldCo then transfers nearly all of its profits – except for a small margin of 0.1% and some staff expenditure to satisfy the Luxembourg tax agencies and the European courts – to another company in the British Virgin Islands (the MasterCo) through so-called profit participating loans that combine small fixed interest rates with interest payments varying according to profits and are historically accepted as debt by the Luxembourg tax agencies. In the British Virgin Islands any profit is taxed at 0%. What happens at the level of the investors is usually impossible to determine with publicly available information but the British Virgin Islands are famous for the anonymity of its corporate structures.

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[11] For a general introduction see: https://en.wikipedia.org/wiki/Entity_classification_election

[12] For a more detailed description see: https://www.projectfinance.law/publications/update-on-luxembourg-holding-companies

Table 1 – Summary financial positions of a typical, simplified tax avoidance structure

(in €)	PropCo	HoldCo	MasterCo
Income	1.000.000	500.000	470.000
Expenses	750.000	20.000	0
Intra-group interest expense	500.000	470.000	0
Profit/loss	(250.000)	10.000	470.000
Tax	0	2.700	0

Real-world examples

To get an idea how common the structure described in the previous chapter is, which variations exist in practice, what has changed since LuxLeaks and how much profit is being shifted, we analyzed case studies from Berlin and several other cities throughout Europe. The case examples summarized below don't claim to be representative, but they show that the problem is real, that it continues and that it's a European problem.

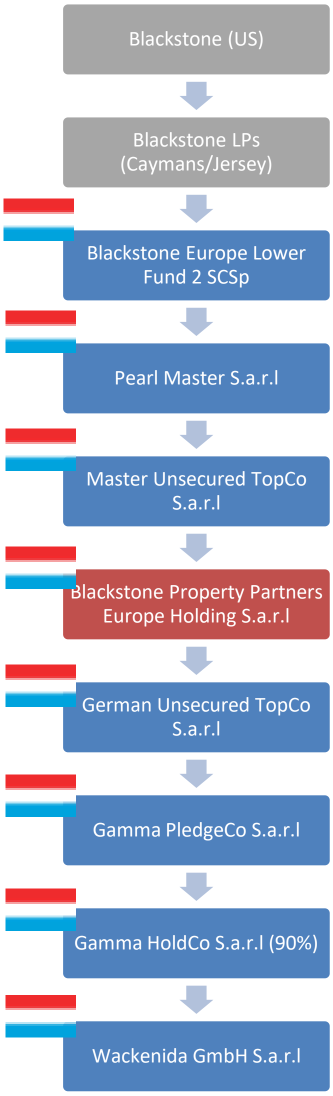

Figure 1 – Blackstone Property Partners Europe, simplified corporate structure (Source: Own representation based on corporate filings)

Blackstone

According to its website, Blackstone is one of the world's biggest investment firms and arguably the biggest real estate investor. It is run by Mr. Schwarzman, a US billionaire, who also founded and then sold the even bigger Blackrock. Blackstone manages US$ 571 billion from its clients – among them pension funds for 31 million US-Americans as well as family offices of the very wealthy – of which US$ 163 billion is invested in real estate worth US$ 325 billion.[13] Blackstone buys undermanaged, well-located real estate (opportunistic), provides funding solutions for real estate (debt) and makes longer-term investments in industrial, residential, office and retail assets in global gateway cities (core+).

One of the vehicles for the latter strategy is Blackstone Property Partners Europe Holdings S.a.r.l ("BPPHE") in Luxembourg. According to its consolidated accounts for 2018 this company held assets worth € 3.62 billion in Germany, France, Spain, Italy, Poland and the Netherlands, with residential investments limited to Germany. BPPHE is imbedded in a complex investment structure (see Figure 1). It is owned through several layers of funds and firms in Luxembourg, the Cayman Islands, Jersey and Delaware (US) and itself lists 154 consolidated subsidiaries from Luxembourg and the countries of investment.

Throughout this investment structure there are

[13] https://www.blackstone.com/the-firm/overview

numerous interest-based loans with interests ranging from 1 to 10% and several profit participating loans (PPLs) granted by the ultimate and intermediary partners with fixed interest rates of 1%. For external financing, BPPHE and the associated entities use several bonds listed at the Guernsey stock exchange with interests ranging from 0.5 to 2.2%[14] as well as loans from several banks at less than 0.9 to 1.2%.[15]

Still according to the 2018 accounts, BPPHE had taken loans from affiliated undertakings totaling € 1.16 billion at interest rates ranging from 1 to 7.93% and deducted interest payments of € 20 million from its rental income of € 79.8 million, creating a loss of € 40.5 million. More details for one of its subsidiaries – Wackenida GmbH S.a.r.l - can be found in Table 2 (below). Newspapers further reported recent Blackstone investments in residential real estate in Copenhagen[16] and Amsterdam[17] using similar structures. From 2013 onwards Blackstone also heavily invested in Spanish real estate[18] - again mostly through Luxembourg. Other investment firms use similar structures throughout Europe, for example Apollo for its investment in Portugal.[19]

Pears

The Pears family from the UK is one of the biggest private investors in Berlin real estate and one of the more opaque. The three brothers inherited big parts of their wealth. According to the website of the Pears foundation, they dedicate around GBP 15 to 20 million per year to charity in the UK.[20] Their investment activities in Berlin have been exposed by a small cooperatively owned bar in Neukölln threatened by eviction using the Danish register of beneficial owners[21] and documented as part of a crowd-based journalism project of the Berlin daily Tagesspiegel and the investigative journalism platform Correctiv.[22] Through investment companies in Luxembourg, Cyprus and the British Virgin Islands the Pears brothers own more than 3.000 apartments in Berlin as well as other assets in Denmark and the Czech Republic.

There are no consolidated accounts accessible for the structure, but summing up the 2017 accounts from the 28 Luxembourg subsidiaries holding real estate in Berlin results in income from rent and sales of about € 50 million, intra-company interest payments of € 17.4 million and an overall loss of € 5 million – even though some of the subsidiaries with high sales income made profits. The total taxes accounted for by the Luxembourg subsidiaries amount to only € 181.000. The Pears subsidiaries used bank loans with rates ranging from 0.9 to 2.128% as well as intra-company loans from two Cypriote companies that are in turn owned by two companies from the British Virgin Islands. There is no information on the interest rate charged in the financial accounts in Luxembourg

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[14] https://www.tisegroup.com/market/companies/6642

[15] According to the consolidated accounts of 2018 the contractual terms were Euribor + 1,05% and Euribor + 1,4%. Euribor rates averaged -0,173% in 2018 (https://de.global-rates.com/zinssatze/euribor/2018.aspx) and were below -0,3% from 2018 to 2020

[16] https://www.dr.dk/nyheder/penge/maries-lejlighed-er-ejet-af-15-selskaber-i-fire-lande-foelg-pengesporet-bag

[17] https://www.parool.nl/amsterdam/is-het-erg-dat-een-omstreden-investeerder-huizen-koopt-in-amsterdam~bbde86c8/

[18] https://www.auraree.com/real-estate-news/blackstone-has-created-a-re-giant-in-spain-worth-e20bn/

[19] https://www.publico.pt/2019/02/12/economia/noticia/casas-compradas-fidelidade-sao-controladas-apollo-partir-ilhas-caimao-1861600

[20] https://pearsfoundation.org.uk/

[21] https://syndikatbleibt.noblogs.org/ Since the end of 2019 the beneficial ownership of the Pears brothers is also confirmed in the beneficial ownership register of Luxembourg.

[22] https://interaktiv.tagesspiegel.de/lab/das-verdeckte-imperium/

and neither in Cyprus nor in the British Virgin Islands financial information is publicly accessible. But the interest charges recorded in Luxembourg average 7,64% of the recorded loan amounts. More detailed data for one of the subsidiaries – Ebony Properties S.a.r.l - can be found in Table 2 (below).

Other residential real estate investors in Berlin

Using a set of ownership information collected from individual tenants throughout Berlin, we found that among foreign investment vehicles, companies from Luxembourg were by far the most common (far ahead of Denmark, Austria or the Netherlands) with most of them using the structure outlined in chapter 1. For a sub-set of subsidiaries from these structures (see Box 4 for more details) we analyzed financial statements.

Box 4: Note on methodology

In Germany the real estate register is accessible only after proof of a legitimate interest – e.g. a tenant asking about his or her landlord. A project of the Rosa Luxembourg foundation collected such information from tenants and analyzed the ownership structures as far as public information on them was available. From this selection of cases, the present study extracted all companies that a) own real estate according to the register (PropCos), that b) use intermediaries in Luxembourg (HoldCos) in their ownership structure and for which c) detailed financial accounts were available. For corporate groups we randomly picked one subsidiary for more detailed analysis. The resulting list is therefore neither complete nor representative but provides detailed insights with regard to the structures actually in use.

The amount of detail provided in the financial reports differs. Luxembourg accounts are usually more detailed than the ones publicly accessible in Germany and while some entities publish full profit and loss statements accompanied by detailed notes, others only publish abridged or no profit and loss statements at all. Where not explicitly available from the notes, rental income had to be approximated from the turnover that usually consists only of rental income but sometimes includes other items such as income from sales of properties. Likewise information on the conditions of third-party and intra-group financing are sometimes explicitly described in the notes or else had to inferred from the information in the profit and loss statement. The resulting rates calculated for our overview are therefore only exemplary snapshots to illustrate the range and magnitude of the issue.

Overall we found that the entities and corporate structures we reviewed:

- Sometimes used PropCos from Germany (especially when recently acquired) but usually established their PropCos in Luxembourg or moved them there;
- Used intra-group interest payments at between 1,82% and 7,64%;
- Created deductible interest payments of 15% up to 55% of their (rental) income;
- Used mark-ups of 1% up to 5.79% for the intra-group loans compared to the third-party financing (often with similar characteristics in terms of date of origin and maturity but with mortgage);
- Transferred intra-group interest payments to no-tax jurisdictions like the Cayman Islands, the British Virgin Islands or to investment vehicles in Luxembourg that only pay a small tax on net assets and no corporate income tax.

Table 2 – Intra-group interest payments and profit shifting in selected cases

Investor	PropCo name (country)	HoldCo	MasterCo	Intra-group interest (% of rent)	Interest (internal)	Interest (external)
Carlyle Group	CER Berlin RP Osloer S.a.r.l (Luxembourg)	Lux	Cayman Islands (LP)/Delaware	55%	4.75%	0.85%
Optimum Evolution Fund	Berlin Project-1 Property III S.a.r.l (Luxembourg)	Lux	Lowly taxed Luxembourg fund	38%	4%	1.85%
Pears brothers	Ebony Properties S.a.r.l (Luxembourg)	Cyprus	British Virgin Islands	35%	7.64%	1.84%
Blackstone Property Partners Europe	KC Chris GmbH (Luxembourg)	Lux	Luxembourg/Cayman Islands/Jersey	24%	1.82%	0.5-2.2%
Puma Brandenburg Limited	Brandenburg Properties 3 S.a.r.l (Luxembourg)	Lux	Guernsey	15%	5.20%	n.a.
Threestones Capital	TSC Berlin Alpha GmbH (Germany)	Lux	Lowly taxed Luxembourg fund	n.a.	6.00%	n.a.

Possible Solutions

Stage 1 – Germany (or other European source countries)

Because taxing rights for real estate are usually allocated to the country where this real estate is located, the source countries have several options to ensure proper taxation such as challenging the interest rates used for intra-group payments, introducing limits or withholding taxes for outflowing interest payments.

Transfer-pricing challenges

In most countries intra-group interest payments are generally deductible unless the tax authorities decide that it's not at arm's length, a decision that can usually be challenged in court.

Information on how often, at what levels and with which result local tax agencies in Germany actually challenge intra-group interest payments is not publicly available. But German tax authorities don't seem to have or apply consistent guidelines on acceptable interest rates. In an analysis of nearly 5.000 German bank loans and bonds Ebeling, Nolden, Overesch, Pflitsch and Wolff (2018) show that only between 2013 and 2017 and credit ratings between B- and A, interest rates varied between 0,005 and 10,9%. This shows how difficult it can be for tax agencies to successfully contest the interest rates used by the real estate investors for their internal loans. When challenged by the press on their use of Luxembourg-based subsidiaries, one of the big companies holding commercial and residential real estate in Germany argued that it is common practice to use intra-company loans.

The reply considered an average of approximately 3% reportedly used by that company as a conservative interest rate compared to the rates used by other companies and in other countries.[23]

In contrast to Germany and many other European countries, France uses a safe harbor rate above which intra-group payments are not deductible unless documentation is provided demonstrating that the interest rate applied is at arm's length – in essence shifting the burden proof from the tax agency to the tax payer. This safe harbor rate is calculated as the average market rate of variable-interest financing with a maturity of more than two years and was set at 1.27% at the end of 2019 – far below the interest rates typically used in our examples.[24] In December 2019, as part of the ATAD implementation law, the German finance ministry proposed a similar rule that would tie the deductibility of intra-group interest payments more closely to the market rates available to the investor based on the risk profile of the group rather than of the individual corporate vehicle.[25] Until June 2020 the proposal remained under negotiation and the business lobby strongly opposed the narrowing of the range and the increased documentation and justification needs for companies when setting transfer prices for interest rates.[26]

Limits for interest deductions

Limits for the deductibility of intra-group (and third-party) interest payments were part of the OECD's recommendations to tackle base erosion and profit shifting in 2015 (BEPS, Action point 4) with explicit reference to the model implemented by Germany.

Germany introduced a limit for interest deductions in 2007 with an initial limit of € 1 million.[27] As part of the stimulus package passed by the coalition of CDU/CSU and FDP following the financial crisis, this limit was increased – first temporarily and then permanently – to € 3 million in 2009[28]. As a consequence, companies with tax residency in Germany can only deduct the higher of € 3million or 30% of EBITDA (which, for companies only holding real estate assets, broadly corresponds to the net rental income derived plus potential capital gain from the disposal for the assets). Because investors typically split their real estate holdings among several PropCos with interest expenses below the € 3 million threshold and the limit applies for each of them individually, their interest expenses are usually not affected under this rule. But for some, increasing the limit to € 3 million made an

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[23] Additional background to the case can be found under: https://www.daserste.de/information/wirtschaft-boerse/plusminus/sendung/swr/aroundtown-100.html

[24] https://bofip.impots.gouv.fr/bofip/5505-PGP

[25] https://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetze_Gesetzesvorhaben/Abteilungen/Abteilung_IV/19_Legislaturperiode/Gesetze_Verordnungen/ATADUmsG/1-Referentenentwurf.pdf;jsessionid=134368D5342A9C998FFAEC5FF26A77CD.delivery2-master?__blob=publicationFile&v=4 (§1a Absatz 1 Satz 2)

[26] A summary of the discussion can be found under: https://www.netzwerk-steuergerechtigkeit.de/die-stille-lobbyschlacht-um-das-anti-steuervermeidungsgesetz/ (in German). The more detailed arguments of the business lobby can be found for example here: https://www.gdv.de/resource/blob/54850/4bc38fbeaa19e287c4d205801eea814a/atad--enttaeuschende-vorschlaege-zum-aussensteuerrecht---download-data.pdf (in German).

[27] Unternehmenssteuerreformgesetz vom 14. August 2017 (BGBL I S. 1912)

[28] Bürgerentlastungsgesetz vom 16. Juli 2009 (Bgbl I S. 1959) und Wachstumsbeschleunigungsgesetz vom 22.12.2019 (§4h Absatz 2 Satz 1): https://www.bgbl.de/xaver/bgbl/start.xav?start=//*%5B@attr_id=%27bgbl109s3950.pdf%27%5D#__bgbl__%2F%2F*%5B%40attr_id%3D%27bgbl109s3950.pdf%27%5D__1519255569598

essential difference.[29] The Paradise Papers revealed how a scheme set-up in 2013 by Deloitte for Meininger – a India/UK-owned German hostel chain – directly profited from the higher limit with intra-group interest payments flowing to the Isle of Man totaling approximately € 5 million.[30] In 2019 Luxembourg adopted a similar rule modelled on the German example, using the same limits.

Withholding taxes

Countries can in theory levy withholding taxes on any payments leaving their territory. But the ability to levy such taxes is usually limited by bilateral DTAs and by EU law. According to the OECD Model Tax Convention of 1977, taxes on interest can be withheld at the source with a limit to 10% if the recipient is the beneficial owner. The concept of conduit companies and beneficial ownership were developed in the commentaries in 2003 and 2014. For the EU, Directive 2003/49 exempts interest and royalty payments between Member States from withholding tax to avoid double-taxation, but limits this exemption to cases where the beneficial owner of the recipient is tax resident in the EU. One of the few European countries that levy a withholding tax on interest payments is Denmark. It is also included in the DTA with Luxembourg.[31] In 2019 Denmark successfully defended its right to levy such a withholding tax for payments from Denmark to Luxembourg (and other EU countries) in the European Court of Justice with recourse to the beneficial owner test (for more details see chapter 3.2).[32] Germany does not levy any withholding taxes on intra-company interest payments.

Limited tax liability for capital gains

According to estimates by Jorda, Knoll, Kuvshinov, Schularick, Taylor (2017), capital gains – meaning value increase – historically made up around one third of the return from real estate investments, the other two thirds being regular rent income. According to the OECD Model Tax Convention and most DTAs in force, the right to tax capital gains from real estate lies with the state where the real estate is located. Nevertheless, these gains often remain untaxed due to regulatory gaps and implementation difficulties. In 2019, Germany has added a limited tax liability for capital gains in companies mainly invested in German real estate starting for gains made after the 1st of January 2019.[33]

Stage 2 – Luxembourg and EU

Luxembourg is not the only EU country enabling profit shifting at a big scale, but our case analysis implies that the use of intra-group interest payments for real estate investments is particularly wide-spread there and that Luxembourg needs to take a tougher stance to limit it. While many important counter-measures can and need to be taken at the level of the individual member states, the EU also has an important role to play as its regulations and rules affect the tools available to the member states to fight tax abuse.

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[29] At the time of the law, experts estimated that increasing the limit would reduce the number of companies affected from 1.100 to 600 and reduce the additional income of €750m by 7%. (Stefan Bach, DIW, 2009: https://www.diw.de/documents/dokumentenarchiv_dwip/75/diw_01.c.97254.de/20090422_stellungnahme%20zinsschranke.pdf)

[30] https://projekte.sueddeutsche.de/paradisepapers/wirtschaft/meininger-hostels-e762618/

[31] Selskabsskattelov (Law on corporation tax), Paragraph 2(1)(d)

[32] Compare Judgement in the case C-115/16 from 26 February 2019, available at: http://curia.europa.eu/juris/document/document.jsf?text=&docid=211053&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=1587405

[33] https://www.haufe.de/personal/personal-office-premium/frotschergeurts-estg-49-beschraenkt-steuerpflichtige-22272-veraeusserungsgewinn-bei-anteilen-nach-17-estg-doppelbuchst-aa_idesk_PI10413_HI2371891.html Neu: §49 EStG Abs. 1 Nr 2 Buchstabe e Doppelbuchstabe cc

Qualifying payments as dividends instead of interest, requiring substance

As outlined above, the decision of qualifying a financing relationship as debt or equity is a case by case decision. The advance tax agreements of the LuxLeaks show how a qualification as debt and therefore tax deductibility and the avoidance of withholding tax on dividends was regularly endorsed by the Luxembourg tax agencies.

Under pressure from the European Commission and international reform efforts Luxembourg made some changes:

1. In 2017, Luxembourg codified some rules on transfer pricing, increased the substance requirements to include some personnel expense in Luxembourg and committed to report mere "conduit" companies to its European partners. But according to observers this did not significantly change the situation for the use of intra-company interest payments for profit shifting via Luxembourg.[34]
2. From 1st of January 2019, Luxembourg implemented ATAD 1.[35] This included an interest limitation rule that largely copied the German model, including the €3 million limit. Like in Germany this doesn't affect the structures described, because it applies only to the interest income net of expenses, which in these structures is usually small thanks to the back-to-back loans. It also included some anti-hybrid measures which also had no impact on the described structures because they were limited to entities tax resident in the EU (which excludes the non-EU resident MasterCos of our examples).
3. In an attempt to address the ongoing criticism from the European Commission, Luxembourg is currently discussing rules that would disallow the deduction of interest payments made to jurisdictions on the EU's list of non-cooperative jurisdictions. Since the Cayman Islands are currently on that list, such a change could potentially make a difference but the exact implementation and the reactions of the industry remain to be seen.[36]

Facilitating the use of anti-abuse legislation by member states

EU legislation – in particular Directive 2003/49 (interest and royalties) and Directive 2011/96 (parent-subsidiary) – and the fundamental freedoms (§49 treaties of the European Union) limit the right of member states to levy withholding taxes and to apply anti-abuse rules. In 2017, in the case Deister Holding[37] against Germany, the European Court of Justice found that German anti-abuse rules were against EU law. In this case, a German tax resident had set-up a Dutch holding company with two employees arguably with the only purpose to avoid the withholding tax on dividend payments applicable in Germany. The Court held that Germany did not proof that the structure was wholly artificial and could not have potentially had an economic justification. Based on this judgement the

[34] https://www.lpea.lu/2017/01/16/new-article-56bis-lir-and-circulaire-lir-n561-56bis1-threat-or-opportunity/

[35] https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package/anti-tax-avoidance-directive_en

[36] https://www.chd.lu/wps/PA_RoleDesAffaires/FTSByteServingServletImpl?path=3AC50E8B762C93D43076E41BA8E59A428E34538F83FC9AB92122378FDCDA955D8546FB10ADA74EEF22396026657285EF$5EE63DE733CB1D375DBEEC4CEA28C036

[37] Joint judgement in the cases C-504/16 and C-613/16 (Juhler Holding A/S) from 30 December 2017, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:62016CJ0504&from=DE

Austrian courts changed their decision and decided that three employees – even if only administrative – were enough to justify a structure helping to avoid Austrian tax.[38]

Nevertheless, a landmark judgement by the ECJ in February 2019 concerning several cases of withholding taxes on interest and dividends applied by Denmark for the tax years 2005 to 2008 allowed a wide application of anti-abuse laws. The cases concerned several investments funds and companies from outside the EU (Cayman Islands, Jersey, Luxembourg investment fund transparent for Danish tax purposes) investing in a Danish company via Luxembourg and Sweden. One of the cases (N Luxembourg) concerned withholding taxes on interest payment through structures comparable to those described in the present study. They were justified by the so-called beneficial owner test, arguing that the Luxembourg recipients of the intra-group interest payments were mere conduits for the beneficial owners from outside the EU for whom the exemption from such withholding taxes doesn't apply.[39] The judgement is worth a closer look. It held that:

"The presence of a certain number of indications may demonstrate that there is an abuse of rights, in so far as those indications are objective and consistent. Such indications can include, in particular, the existence of conduit companies which are without economic justification and the purely formal nature of the structure of the group of companies, the financial arrangements and the loans."

And further:

"[…]the artificiality of an arrangement is capable of being borne out by the fact that the relevant group of companies is structured in such a way that the company which receives the interest paid by the debtor company must itself pass that interest on to a third company which does not fulfil the conditions for the application of Directive 2003/49, with the consequence that it makes only an insignificant taxable profit when it acts as a conduit company in order to enable the flow of funds from the debtor company to the entity which is the beneficial owner of the sums paid. […] The absence of actual economic activity must, in the light of the specific features of the economic activity in question, be inferred from an analysis of all the relevant factors relating, in particular, to the management of the company, to its balance sheet, to the structure of its costs and to expenditure actually incurred, to the staff that it employs and to the premises and equipment that it has. […] The way in which the transactions are financed, the valuation of the intermediary companies' equity and the conduit companies' inability to have economic use of the interest received may also be used as indications of such an arrangement. In this connection, such indications are capable of being constituted not only by a contractual or legal obligation of the company receiving interest to pass it on to a third party but also by the fact that, 'in substance', as the referring court states in Cases C-115/16, C-118/16 and C-119/16, that company, without being bound by such a contractual or legal obligation, does not have the right to use and enjoy those sums."

This interpretation of artificiality and abuse significantly increases the space for member states willing to introduce and apply withholding taxes to payments channeled through another member

[38] An analysis of the initial judgement can be found at: https://steuernachrichten.pwc.at/blog/2018/06/20/bfg-erkennt-missbrauch-bei-anwendung-der-mutter-tochter-richtlinie/ (in German), the judgement of the court of appeal is analyzed at: https://steuernachrichten.pwc.at/blog/2019/06/25/vwgh-hebt-erkenntnis-des-bfg-bezueglich-missbrauch-bei-kest-rueckerstattung-auf/ (in German)

[39] See judgement of case 115/16 (N Luxembourg 1) of 26 February 2019, available at: http://curia.europa.eu/juris/document/document.jsf?text=&docid=211053&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=1587405

state. Whether it holds in future cases remains to be seen and member states should not hesitate to test this new space by bringing their own cases.

Stage 3 – Globally

While the measures within the existing international framework at the level of the member states and at the EU-level could make a difference – as outlined above – the issue of profit shifting should and is being addressed at the international level. Large parts of the international reform efforts are focused on multinational corporations, especially those with digital business models, but the investment industry should not be forgotten. Thanks to their special characteristics many of the measures already decided don't apply, but – if designed correctly – a minimum tax could make a big difference for tax collection.

ATAD 2

Tax rules are discussed and agreed at international level, but have to be incorporated eventually into national tax laws and are implemented at the national level. The OECD's actions against base erosion and profit shifting (BEPS) agreed on in 2015 were implemented through two anti-tax avoidance directives at EU level, Directive 2016/1164 (ATAD 1) and the amendment through Directive 2017/952 (ATAD 2) and were supposed to be implemented in national law until 1st of January 2019 and 1st of January 2020 respectively. ATAD 2 addresses hybrid mismatches with third countries. Among others this affects hybrid financial instruments that are treated as debt in Luxembourg, so to generate deductible interest expenses, and treated as equity in the lender jurisdiction, benefitting from exemption generally granted to payments in the form of dividends (e.g. the PECs/CPECs, see Box 3). Luxembourg has approved the national implementation on 20th of December 2019[40], in Germany negotiations are still going on.

Early evaluations of the tax industry pointed out that the law might have some impact on the "tried-and-tested instruments and structures", but point out several ways to adjust them to the new rules.[41] One of the central points is the limitation of ATAD 2 to associated enterprises. ATAD 2 is applicable only to entities that are controlled (50% of voting rights, shares or profits, under some circumstances also 25%) or part of the same consolidated group. In a typical investment fund structure most investors will fall below and outside of these benchmarks. ATAD 2 further provides a so called "acting together" clause to avoid fragmentation of shares and voting rights to circumvent the rules. But Luxembourg has introduced a reverse burden of proof for this acting together test, meaning that investors holding less than 10% of the shares are deemed not acting together unless the tax administration proves otherwise.[42]

GloBe

Currently the OECD is negotiating about another reform package for international corporate tax rules, sometimes referred to as "BEPS 2.0". This package contains proposals to redistribute some taxing rights- especially for consumer-facing companies and companies with digital business models – to market jurisdictions, i.e. the countries where the products are sold, using a formulaic approach (so-called "Pillar 1"). It also contains proposals to ensure that every company no matter where it is

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[40] https://www.chd.lu/wps/portal/public/Accueil/TravailALaChambre/Recherche/RoleDesAffaires?action=doDocpaDetails&backto=/wps/portal/public/Accueil/Actualite&id=7466

[41] https://blog.kpmg.lu/atad-2-and-its-impact-on-luxembourg-based-private-equity-funds/

[42] https://www.lpea.lu/wp-content/uploads/2019/11/lpea-atad-2-and-pe-funds-30-october-2019.pdf

based or how it is structured pays a global minimum tax (so-called "Pillar 2"). If well designed, Pillar 2 could make a big difference for investment funds that at the moment are very often virtually untaxed. Applied to the structures analyzed in this study such a rule should, in essence, allow Germany to tax any profits related to German real estate at the agreed minimum tax unless Luxembourg or the target country of the profits being shifted through Luxembourg does so. In case both sides – Germany and the target country – would decide to levy the minimum tax a mechanism to avoid double taxation, i.e. ordering rules and tax credits, would apply.

One possible and effective way to design such a tax would be modeled around the concept of limited tax liability. Just like source countries can already subject profits from real estate in their territories to tax and make foreign companies owning such real estate handing in tax declarations for that income, they could oblige any company that receives payments from economic activity in its territory to prove that profits related to this activity are effectively taxed according to the internationally agreed or nationally set minimum rates. In practice this could mean that the PropCos from Luxembourg would not only have to hand in a tax declaration concerning their German real estate income, but in addition provide the German tax agencies with proof – for example in the form of tax declarations and tax decisions – of the taxation at the level of the ultimate recipient.

Conclusion

A significant number of professional investors, especially investment funds, private equity companies from the US and big family offices channel real estate profits out of Europe virtually untaxed. The exact magnitude of the damage remains unknown but macroeconomic data shows that they often use intra-group interest payments routed via Luxembourg. Existing reform efforts against profit shifting have not been sufficient to address this problem. There are a range of measures already successfully used or tested by some EU member states or discussed the global level, that could make a difference. In particular:

Germany (and other source countries in the EU), should:

- Effectively limit the abuse of transfer pricing regulations by stricter scrutiny of tax declarations and by more narrowly defining appropriate interest rates for intra-group financing like the safe harbor rule in France or solutions currently discussed in Germany;
- Introduce a withholding tax on intra-group interest payments like Denmark;
- Ensure that capital gains from selling real estate are taxed in Germany;
- Introduce a limited tax liability for undertaxed payments in global coordination or unilaterally if necessary.

The EU should:

- Ensure that all member states apply tax and transfer pricing rules appropriately and don't offer harmful tax structures;
- Support EU member states to contest abusive structures in the European Court of Justice and change Directives 2003/49 (interest and royalties) and 2011/96 (parent-subsidiary) making effective minimum taxation in the conduit or target country a precondition for their application;
- Support global negotiations for an effective minimum tax or agree on EU-wide mechanisms if necessary.

The international community, especially the OECD and G20 should agree on an ambitious global minimum tax without exemptions for the investment industry and with a strong mechanism for source countries to tax outgoing-payments modelled for example on the existing limited tax liability.

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