IE University IE International Policy Review (IPR)
Journal **6** **Issue 1** (2025)
https://ipr.blogs.ie.edu/

Exploring Base Erosion and Profit Shifting in the Context of Conflicting National Interests.

Iker Graña

School of Politics, Economics and Global Affairs, IE University, Madrid, Spain

Bachelor in Business Administration and International Relations

E-mail: igrana.ieu2023@student.ie.edu

Published 27th January 2025

Abstract

The article seeks to explore the issue of Base Erosion and Profit Shifting in Europe. The recent victory of the European Commission on Apple, which forces it to pay 14 Billion dollars back to Ireland, has shown progress while raising fears of destabilizing international investment. The article argues that harmonizing tax codes and closing loopholes will both balance national sovereignty and curve tax avoidance.

Keywords: tax governance, Apple, OECD, tax heaven, tax avoidance

1. Introduction

Are tomatoes a vegetable or a fruit? This simple question was the topic of debate in Nix v. Hedden, a case taken by the United States Supreme Court in 1893. The Tariff Act of 1883 had placed duties on vegetables, but not fruit. Armed with the botanical knowledge that a tomato, is indeed, classified as a fruit, the John Nix & Co. company sued the Port of New York to recoup paid tariffs on their tomato imports. The court unanimously sided with the port, declaring that for tax and tariff purposes, a tomato is legally considered a vegetable, much to the horror of pomologists everywhere.[1]

This story showcases the lengths companies are willing to go to avoid paying taxes. Since the 19th century, tax avoidance has only grown in scope and impact. In 2014, the International Consortium of Investigative Journalists (ICIJ) leaked 28,000 pages of documents corresponding to more than 340 American based companies who worked with Price Waterhouse Coopers. They detailed how some of these companies managed to pay less than 1% in taxes by

[1] Nix v. Hedden (United States Supreme Court May 10, 1893).

shifting profits to Luxembourg, in a move completely in accordance with the nation's laws.[2] The ordeal became known as the luxleaks. The leak came soon after Jean-Claude Juncker became the new head of the European Commission (EC), the body responsible for investigating such affairs. He had served as Prime Minister of Luxembourg during the time the deals took place. Thus the leaks called into question the impartiality of politicians on such matters. Soon enough, however, an even bigger leak would break.

On April third of 2016, over 2.6 Terabytes of data were leaked from the Panama-based law firm Mossac Fonseca, detailing how the firm's clients abused the legal tax system to pay as little in taxes as possible.[3] The leak, also published by the ICIJ, did not uncover anything strictly illegal. Nevertheless, it was decried by many around the world as an example of the double standard taxation that exists between the wealthy and the impoverished. Calls to do something about it such actions became abundant.

Partly in response to the outrage on the matter, the Organisation for Economic Co-operation and Development (OECD), a club of mostly rich countries, launched the Base Erosion and Profit Shifting (BEPS) program to fight international tax avoidance. At its inaugural meeting in 2016 82 countries joined and pledged to incorporate measures to fight BEPS, including Ireland and Luxembourg.[4] Yet, this initiative hasn't been able to stop today's biggest companies from continuing to find creative ways to run from the taxman.

Apple, one of the most valuable companies in the world, famously abused global tax laws by exploiting the double Irish loophole, which in combination with favourable deals with the Irish tax authority, allowed it to effectively pay close to no taxes. The loophole abuses tax regulation recommendations by the OECD and Irish and American tax law inconsistencies to, for tax purposes, have no country to report to.[5] This situation creates an unfair advantage for Apple in the European Union, as it allows it to invest more capital in its operations and gain an unfair advantage over its competitors. In 2016 the EC, in an initiative championed by the Competition Commissioner Margrethe Vestag, ordered Apple to repay 13 Billion US dollars back to Ireland in uncollected taxes, accusing Ireland of having granted Apple illegal state aid.[6]

The mood in Dublin seemed somehow worse than the one in Cupertino. Ireland's finance minister at the time, Michael Noonan, proclaimed "We will fight it at home and abroad and in the courts."[7] They alleged that the EC had compromised their tax sovereignty and feared that the move could constrain foreign investment, particularly from

[2] Vanessa Houlder, "Leak Reveals Scale of Corporate Tax Deals with Luxembourg," www.ft.com, November 6, 2014, Link.

[3] The Economist, "A Torrential Leak," The Economist, April 9, 2016, Link

[4] "Base Erosion and Profit Shifting (BEPS)," OECD, 2024, Link.

[5] Rita Barrera and Jessica Bustamante, "The Rotten Apple: Tax Avoidance in Ireland," The International Trade Journal 32, no. 1 (August 2, 2017): 150–61, Link.

[6] Javier Espinoza, Jude Webber, and Emma Agyemang, "Financial Times," FinancialTimes, September 10, 2018, Link.

[7] The Economist, "Upsetting the Apple Cart," The Economist, September 8, 2016, Link

the United States. America for its part also took issue with the decision, with the US Treasury department siding with Apple. If anything, they claimed, it was America's right to claim those taxes.[8]

The issue of BEPS is causing disarray in cabinet-meetings as much as it is in board-ones. The different interests of countries are causing strife and creating disunity in the face of a challenge countries can only overcome by working together.

This paper seeks to critically examine the present situation. It finds that harmonising tax codes and simplifying international tax regimes is the best way to curb BEPS. Such an objective would require extraordinary cooperation from different jurisdictions, but recent events might force them to accept.

II. Balancing state sovereignty and international cooperation

After the end of the Cold War, the world became increasingly interconnected. The rise of globalisation and the modern multinational changed the taxation paradigm. These newly emerging international firms became, in some cases, even more powerful than nations themselves. With the aim of maximising profits, these firms began to engage in profit shifting, recording and paying taxes on earnings from a certain territory in a different territory, with a far more favourable tax regime. These nations benefited from the additional income and were able to reinvest it to grow more powerful. However, despite the superficial legality of these actions, they remain anything but popular in the firms' home countries, as these arrangements cost billions in lost tax revenues and flaunt norms of fairness and redistribution. The Tax Justice Network estimates that every year the US is losing 140 billion US dollars to "global tax abuse committed by multinational corporations."[9] After many leaks, such as the aforementioned Luxleaks and the Panama Papers, people became infuriated by the apparent greediness of these firms. Thus, in 2013 the G20 tasked the OECD to find a solution to the problem. This effort resulted in 2015 in the Base Erosion and Profit Shifting (BEPS) initiative, which had its first meeting in 2016.[10] The initiative includes 15 points, one of which particularly discusses the importance of global cooperation. Some authors have critiqued its overreliance on mutual cooperation, as it fails to account for the economic interests of nations.[11]

Under normal circumstances, most countries would celebrate being able to collect an additional $ 13.8 billion in taxes. But, in the case of Ireland, both politicians and the broader population objected to the decision by the EC.[12] Ireland and the citizens at large believe that their

[8] Ciara Graham and Brendan K. O'Rourke, "Cooking a Corporation Tax Controversy: Apple, Ireland and the EU.," Critical Discourse Studies 16, no. 3 (January 24, 2019): 298–311, Link.

[9] "United States - Tax Justice Network," Tax Justice Network, 2021, Link.

[10] Dhammika Dharmapala, "What Do We Know about Base Erosion and Profit Shifting? A Review of the Empirical Literature," Fiscal Studies 35, no. 4 (December 2014): 421–48, Link.

[11] John Paul, "Global Tax Governance or National Tax Discrimination: The Case of the EU vs. Apple," Social Science Research Network 39, no. 15 (April 13, 2019).

[12] Graham and O'Rourke, "Cooking a Corporation Tax Controversy: Apple, Ireland and the EU.," 298–311.

business-friendly model provides an important part of the country's output. For instance, using the same data from the Tax Justice Network, "by enabling global corporate tax abuse," Ireland makes other countries lose $ 11 billion a year.[13]

The pursuit of Apple by the European Commission threatens to dissuade large companies from investing in Ireland for profit shifting. The interests of Ireland stand in direct opposition to those of the European Union on this tax matter. However, the United States is not celebrating the recent ruling by the European Court. The US sees the Europeans as taking money for themselves that they should instead be collecting.[14] The EC has made two enemies: Ireland and the United States. This threatens European integrity, foreign trade relations, and national sovereignty.

Not enough research has been done on potential policy measures that can be taken to address the conflict of interests. The BEPS initiative provides a potential framework and harmonising force. Proposition number 15 advocates for treaties to standardise global tax law and eliminate profit shifting, but thus far little has been accomplished. If countries fail to cooperate, institutions like the EC would be forced to intervene. But such an intrusion on a state's sovereign right to tax, regardless of the pretext of illegal state aid, risks further alienating tax havens and hampering collaboration. Additionally, it presents a risk to foreign investment, a variable of key economic importance. Therefore, this paper will study how the BEPS initiative can best resolve the conflict of national interests and international obligations.

This paper employs a case study approach to analyse potential solutions. Specifically, it looks at the case study of Apple avoiding taxes through Ireland. The paper uses descriptive and explanatory analysis to analyse why the situation came about, while normative analysis is used to understand how the situation could have been solved without compromising Ireland's sovereignty and to prevent similar loopholes from being exploited by companies and countries going forward.

III. Applying Game Theory

The stated conflict can be modelled by a prisoner's dilemma game. If countries decide to cooperate, they can both obtain a sensible and fair amount of tax revenues. But, if one country decides to become a "tax haven" and implement overly business-friendly policies, it will bring in extra tax revenues from countries installing operations and increased foreign investment. If in response, the other country follows suit and also implements a low tax regime, both countries would enter into a tax race. This could potentially force both countries to lower their taxes, leading to a downward spiral that would leave both worse off than to start with.

This final situation is known as a Nash equilibrium, where both countries cannot improve their situation by changing their strategy. This is the situation that the EC

[13] "Ireland," Tax Justice Network, n.d., Link.

[14] Boyu Wang. "After the European Commission Ordered Apple to Pay Back Taxes to Ireland: Ireland's Future in the New Global Tax Environment." Indiana Journal of Global Legal Studies 25, no. 1 (2018): 539–64.

wants to avoid. By interfering and ensuring that competition is fair, the commission seeks to prevent non-cooperative parties. A 2020 report by the Tax Justice Network found that the EU lost over 27 billion a year to countries like the United Kingdom, Switzerland, Luxembourg, and the Netherlands.[15] Instead of joining in the competition, the EU wants to prevent such a Nash equilibrium from occurring.

However, it does not seem like this Nash equilibrium happens naturally, at least in the EU. In a special report published in 2007 by The Economist, they point out that "as a proportion of GDP, total tax revenues have increased steadily over the past 30 years even as statutory tax rates have fallen."[16] Therefore, it seems that no Nash equilibrium exists, as the extra tax revenues brought about by attracting foreign investment make up for the decrease in tax rates. The European Union might be fighting a non-existent battle.

Yet there seem to exist benefits to these tax havens for a company's home country. When a firm utilises a tax haven to save on costs, it simultaneously invests more in its domestic operations. In other words, tax havens do not divert economic activity, and if anything, they increase domestic demand and investment.[17] In fact, foreign direct investment looks to not be a zero sum game. Instead, it can lead to economic benefits in other countries in the form of research and development and capital investment by national firms.[18] This does not negate the other negative effects of profit shifting by corporations, such as starving public welfare funds and violating generally agreed-upon moral norms, but it might help explain why this move came from the EC instead of a member state.

The issue that allowed loopholes like the one abused by Apple and Ireland is the complicated nature of the global tax code. According to Feargal O'Rourke, who, much to his displeasure, is known as the father of the Double Irish exploit, was quoted in 2015 in an interview by The Irish Times saying that the BEPS initiative is "very good" for Ireland.[19] Beyond contributing to a media paradigm that advocates for Ireland's tax strategy, he makes a salient point. He claims that companies, in addition to tax avoidance, simply look for simplicity and stability in what has become an overly complicated global tax regime. To that end, the OECD's plan to standardise the international tax system might benefit companies. In turn, the EC's actions do exactly the opposite, and risks hurting foreign investment in the European Area.

IV. Analysing the situation

Returning to the example of the prisoner's dilemma, despite the apparent lack of a Nash equilibrium, there are

[15] "EU Loses over $27 Billion in Corporate Tax a Year to UK, Switzerland, Luxembourg and Netherlands," Tax Justice Network, April 17, 2020, Link.

[16] The Economist, "Places in the Sun," The Economist, February 24, 2007, Link.

[17] Mihir A Desai, C Fritz Foley, and James R Hines, "Do Tax Havens Divert Economic Activity?," Economics Letters 90 (2006): 219–24, Link.

[18] Mihir A Desai, C Fritz Foley, and James R Hines, "Foreign Direct Investment and Domestic Economic Activity," National Bureau of Economic Research, January 1, 2005.

[19] Fiona Reddan, "Scion of a Prominent Political Dynasty Who Gave His Vote to Accountancy," The Irish Times, May 8, 2015, Link.

other forms of tax competition. Special deals and court decisions, which the EC has decried as state aid, are used throughout the whole continent to secure foreign investment. The difference between Ireland cutting Apple a sweat-heart tax deal and Germany investing billions in frozen Intel factories, in terms of the label state aid, are hard to see. This, in turn, complicates the tax code, as countries compete to attract investment.

In today's globalised age it is impossible, and highly undesirable, to do away with multinationals and foreign investment. Ergo, in order to simplify the tax code, national tax systems need to be displaced by an international platform. The evident issue is convincing countries to give up their Westfalian right to tax within their borders.

But the EC's actions might have created the needed impetus for change to happen. For many years Ireland remained comfortable in its status quo. This victory signals that Ireland's and other tax haven's business as usual won't be tolerated. The electoral win of Donald J. Trump and his alleged tariff measures will add to the feeling of uncertainty with regards to foreign investment and trade. This might just force these countries to the negotiating table. In spite of the downfalls and shortcomings of the EC's approach, it might be the much needed catalyst for progress.

The opportunity should be used to draft an international agreement. However, as a concession to state sovereignty, there should be some room to manoeuvre with regards to the percentage taxed. Rather, the focus of negotiations should be on closing loopholes like the Double Irish Taxation. The issue stemmed from inconsistencies with OECD rules. Closing them and agreeing upon a universal set of taxation rules on who should tax based on where income is generated is a better solution.

V. Conclusion

The OECD's BEPS initiative represents a step in the right direction; however, its reliance on multinational cooperation has compromised its ability to create substantial progress. Countries hold strong incentives to pursue foreign investment-attracting policies, sometimes to the detriment of other neighbouring states. Yet, there are also economic benefits from residing in proximity to these tax havens.

Many citizens in these countries see these tax regimes as a cornerstone of their economy, and without them countries like Ireland would be economically compromised. This makes these countries effectively become opposition to BEPS curving-initiatives, while they reside on the governing board of these countries, representing a major conflict of interest.

The major issue at hand is that of tax complexity. Harmonising tax codes is a necessity in the fight against BEPS, beyond simply requiring certain tax minimum percentages, it is imperative that countries agree on a standard for taxing a company's income. Current inconsistencies allow for the Double Irish loophole and other tricks. Getting the different parties to agree will be an arduous challenge.

But current events are preparing the container for such a situation. The victory of the EC over Apple and Ireland signals that they can repeat this trick in other countries. President-elect Trump's threats add additional urgency to opening negotiation channels. Drafting an accord that crushes international tricks while preserving the sovereignty of states can help alleviate the situation.

Another cause for glee is the internal push by some countries to reform their economy. The aforementioned threats make the tax haven model unsustainable. Luxembourg for instance, is seeking to lose that label and stand on its own two feet economically.[20] If it succeeds, it will show similar countries around the world that there is another way. More importantly, it will show that troublemakers can change for the better, and that companies will have to find new places to escape taxes from.

[20] Alex Irwin-Hunt , "Luxembourg Tries to Shed 'Tax Haven' Label," www.ft.com, November 15, 2020, Link.

VI. Bibliography

Barrera, Rita, and Jessica Bustamante. "The Rotten Apple: Tax Avoidance in Ireland." The International Trade Journal 32, no. 1 (August 2, 2017): 150–61. https://doi.org/10.1080/08853908.2017.135625.

Desai, Mihir A, C Fritz Foley, and James R Hines. "Do Tax Havens Divert Economic Activity?" Economics Letters 90 (2006): 219–24. https://doi.org/10.1016/j.econlet.2005.08.007.

Desai, Mihir A, C Fritz Foley, and James R Hines. "Foreign Direct Investment and Domestic Economic Activity." National Bureau of Economic Research, January 1, 2005.

Dharmapala, Dhammika. "What Do We Know about Base Erosion and Profit Shifting? A Review of the Empirical Literature." Fiscal Studies 35, no. 4 (December 2014): 421–48. https://doi.org/10.1111/j.1475-5890.2014.12037.x.

Espinoza, Javier, Jude Webber, and Emma Agyemang. "Financial Times." FinancialTimes, September 10, 2018. https://www.ft.com/content/d6b7d0fd-a41b-45a9-a830-9cacb10c5151.

Graham, Ciara, and Brendan K. O'Rourke. "Cooking a Corporation Tax Controversy: Apple, Ireland and the EU." Critical Discourse Studies 16, no. 3 (January 24, 2019): 298–311. https://doi.org/10.1080/17405904.2019.1570291.

Houlder, Vanessa. "Leak Reveals Scale of Corporate Tax Deals with Luxembourg." www.ft.com, November 6, 2014. https://www.ft.com/content/93e75c1a-6545-11e4-91b1-00144feabdc0.

Irwin-Hunt , Alex. "Luxembourg Tries to Shed 'Tax Haven' Label." www.ft.com, November 15, 2020. https://www.ft.com/content/ebfea57b-ce1c-4e1d-8b08-640d1a87ff99.

Nix v. Hedden (United States Supreme Court May 10, 1893).

OECD. "Base Erosion and Profit Shifting (BEPS)," 2024. https://www.oecd.org/en/topics/policy-issues/base-erosion-and-profit-shifting-beps.html#beps-actions.

Paul, John. "Global Tax Governance or National Tax Discrimination: The Case of the EU vs. Apple." Social Science Research Network 39, no. 15 (April 13, 2019).

Reddan, Fiona. "Scion of a Prominent Political Dynasty Who Gave His Vote to Accountancy." The Irish Times, May 8, 2015. https://www.irishtimes.com/business/financial-services/scion-of-a-prominent-political-dynasty-who-gave-his-vote-to-accountancy-1.2203820.

Tax Justice Network. "EU Loses over $27 Billion in Corporate Tax a Year to UK, Switzerland, Luxembourg and Netherlands," April 17, 2020. https://taxjustice.net/press/eu-loses-over-27-billion-in-corporate-tax-a-year-to-uk-switzerland-luxembourg-and-netherlands/.

Tax Justice Network. "Ireland," n.d. https://taxjustice.net/country-profiles/ireland/.

Tax Justice Network. "United States - Tax Justice Network," 2021. https://taxjustice.net/country-profiles/united-states/.

Wang, Boyu. "After the European Commission Ordered Apple to Pay Back Taxes to Ireland: Ireland's Future in the New Global Tax Environment." Indiana Journal of Global Legal Studies 25, no. 1 (2018): 539–64. https://doi.org/10.2979/indjglolegstu.25.1.0539.

"A Torrential Leak." The Economist, April 9, 2016. https://www.economist.com/international/2016/04/09/a-torrential-leak.

"Places in the Sun." The Economist, February 24, 2007. https://www.economist.com/special-report/2007/02/24/unintended-consequences.

"Upsetting the Apple Cart." The Economist, September 8, 2016. https://www.economist.com/europe/2016/09/08/upsetting-the-apple-cart.