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Dr hab. Dominik Jan Gajewski, prof. SGH

Warsaw School of Economics
ORCID: 0000-0002-7935-9221
e-mail: dominik.gajewski@sgh.waw.pl

Selected methods of countering treaty shopping in the context of cross-border activity of groups of companies

Wybrane metody przeciwdziałania zjawisku *treaty shopping* w kontekście działalności transgranicznej grup kapitałowych

Abstract

The subject-matter of the elaboration is the mechanism of treaty shopping which is used not only for tax optimization but also tax avoidance. The main beneficiaries of this mechanism are groups of companies running cross-border activity. A special aspect that undergoes analysis in this article are the methods of countering treaty shopping. The issue is directly concerned with the aspects of both domestic tax law and international double taxation agreements. The mechanism of treaty shopping is also connected with the problem of withholding tax. The purpose of the elaboration is to evaluate the effectiveness of the methods of countering treaty shopping in connection with the operation of international holding companies.

Keywords: tax, CIT, treaty shopping, tax optimization, holding

JEL: K22, K33, K34

Streszczenie

Przedmiotem opracowania jest mechanizm *treaty shopping*, który wykorzystywany jest nie tylko do optymalizacji opodatkowania, ale również do unikania opodatkowania. Głównym beneficjentem tego mechanizmu są grupy kapitałowe funkcjonujące transgranicznie. Szczególnym aspektem analizowanym w artykule są metody przeciwdziałania *treaty shopping*. Z problematyką tą bezpośrednio związane są aspekty zarówno z zakresu wewnątrzkrajowego prawa podatkowego, jak i międzynarodowych umów o unikaniu podwójnego opodatkowania. Z mechanizmem *treaty shopping* wiąże się również problematyka podatków potrącanych u źródła. Celem opracowania jest ocena skuteczności metod przeciwdziałania *treaty shopping* na gruncie działalności holdingów międzynarodowych.

Słowa kluczowe: podatek, CIT, *treaty shopping*, optymalizacja podatkowa, holding

Introduction

In times of globalisation, tax optimization methods are more and more commonly used in settlements of cross-border related parties. As far as methods used in tax strategies of international holding companies are concerned, it is becoming more and more difficult for tax bodies to differentiate between permissible methods available in domestic and international tax law and the illegal ones. One of the methods employed in tax planning is treaty shopping that has gained quite a lot of popularity. Therefore, selection of the right method of countering treaty shopping is key for the process of fighting international tax avoidance. Making the right choice must be preceded by an in-depth analysis of the environment in which treaty shopping takes place.

Appropriate use of the applicable agreements on the avoidance of double taxation (AADT) is essential for holding companies to internationally optimize their tax policies. However, occasionally the law is used for the purpose of international tax optimization in a manner inconsistent with its original purpose. This is primarily connected to so-called treaty abuse and the use of an AADT's provisions by entities not entitled to do so (also known as treaty shopping).

In general, the phenomenon of treaty abuse is concerned with inappropriate use of an agreement's provisions, where "inappropriate" does not necessarily denote the commission of an offense or a formal breach of an AADT's provisions.

The phenomenon of treaty shopping is concerned with particular financial actions (i.e., financial operations) outside the borders of a taxpayer's state that consist of applying the provisions of a control AADT and consequently, gaining advantage in the form of a reduction in foreign tax (Wyciślok, 2010, p. 15).

International tax-law doctrine provides several slightly differing definitions (Van Weeghel, 1998, p. 117; Valente&Magenta, 2000, p. 41) of this phenomenon; however, the nature of treaty shopping involves an entity not entitled to the benefits of an agreement using another entity to achieve its aim. To recap, one might state that treaty shopping is the practice of using an AADT by making transactions or establishing entities in other states exclusively for the purpose of using the AADT's provisions that apply to relationships between an involved country and the third country. The agreement in question could not be applied in any other case because the entity making use of the preferential conditions is not a resident of a state that is a party.

International holding companies that follow a tax-planning policy frequently use treaty shopping as an instrument for avoiding tax. Methods for countering this phenomenon also have profound significance for holding companies' tax strategies. It is necessary to perform an analysis of these methods because they offer the possibility of comprehensively appraising treaty shopping from the perspective of holding companies' tax optimization. Additionally, such an analysis may also prove that "circumventing" the methods for countering treaty shopping is relatively easy, which makes tax avoidance widely achievable.

The policy of countering treaty shopping is significant for holding companies attempting to optimize taxation. Two aspects of this issue must be considered because measures for countering this type of tax avoidance may have a legal basis in states' statutory laws or in AADTs. Accordingly, there are unilateral and multilateral legal solutions that may be adopted to counter treaty shopping.

It must be noted that the nature of unilateral tax regulations that counter treaty shopping may vary. Some may apply to all forms of tax avoidance or evasion regardless of whether a transaction is domestic or international. Others, however, are related only to specific situations related to treaty benefits. Depending on the scope and manner of application, national regulations are often considered controversial because of their influence on legal obligations arising out of AADTs.

Controversy may arise from uncertainties about whether it is appropriate to apply general tax regulations where an AADT exists. It seems that national legal solutions may not be applied in situations related to tax treaties when an AADT contains provisions that prevent its inappropriate use (Endres, Schreiber, Dofmuller, 2006, p. 48). Contrary opinions depend on an understanding of the fundamental aim served by such agreements. Moreover, the freedom to interpret the provisions stipulated in the agreements, leading to possibly diverse conclusions, may also be a source of problems. Most countries, however, rely on the Vienna Convention, which enshrines the rule that a general interpretation is equally binding on both parties. Conversely, some states favor a contractual approach to tax conventions. It is argued that international agreements are concluded in the specific context of mutual ties between states and at a specific time. This means that the parties negotiating an agreement act in their specific interest, reflecting their own tax and economic policies. Such an approach may be described as an autonomous interpretation of the provisions stipulated in bilateral agreements based on the supreme principle of tax jurisdictions' sovereignty. Unfortunately, such a stand always leads to conflict between national and international tax laws, which is a factor causing the escalation of activities aimed at tax reduction. One may assume that notions that are not defined in a treaty are interpreted with reference to the national laws of the contracting states.

Another view justifying the use of national law with respect to relationships arising out of an AADT is based on the will of the contracting states, which confer on each other the entitlement to interpret the international agreement in accordance with the economic substance and structure of a transaction (legal act) to which the provisions of the tax treaty are applicable. The form of a legal act is of secondary importance compared to its legal and tax consequences. Thus, the application of a tax treaty is based on the parties' consistent intention and the goal of a legal act. Such an approach is strictly related to the national law of state-parties to an AADT because arriving at a consensus between those parties is possible only on that basis. It is necessary, however, to develop some standards of conduct that cannot be clearly defined in an agreement as far as economic factors are concerned, in contrast to the form of a legal act (Orlov, 2005, p. 38).

Some EU Member States use measures to directly prevent tax avoidance that are nonetheless relevant to the entire tax system and thus take the form of general (or other similar) clauses. An apparent legal act aimed exclusively at producing a particular tax consequence does not deserve to be treated advantageously in the light of national law because a tax advantage that contradicts either the rules of tax law or a general understanding of the law may not receive legal protection. However, the success of such clauses depends on their applicability in courts and by tax authorities.

Unilateral legal solutions are most commonly adopted when national legal regulations are intended to directly counter treaty shopping. Some EU Member States reserve the right of precedence of national legal regulations. However, basic conditions must be met: the provisions of national law must come into effect after the agreement has been signed; and statutory authorization is necessary to apply them, giving them precedence over international agreements if to do so is consistent with the law.

It is also noteworthy that implementation of such legal measures in national statutory law primarily depends on a given state's understanding of how to fulfill its international obligations under its agreements. Moreover, it is necessary for unilateral legal regulations intended to eliminate the practices of treaty shopping to be precise and to have a relatively narrow scope. The literal application of contractual provisions with precedence over national law should (but to a very limited extent) be left to the discretion of courts that may apply national law in the event that there is a danger that international agreements will be circumvented.

Specifics of treaty shopping

Treaty shopping is multifaceted and multidimensional. The issue of the withholding tax is certainly of great importance with respect to the application of unilateral legal measures. It is worth highlighting that treaty shopping is chiefly concerned with taxes withheld and collected at their source, which are imposed on passive incomes such as dividends, interest, and royalty payments. Tax burdens arising in connection with dividends with respect to withholding tax are usually high, because dividends are often subject to double taxation at the level of the company that first distributes the dividend and again as the shareholder's income. The amount of such tax is limited by the applicable AADTs; however, reduction in the rate of this tax is uneven and the range of tax rates between high- and low-tax countries may have a significant influence over the amount of net income.

Thus, it should be noted that withholding taxes are the source of two principal types of problems that must be addressed by the interested holding companies. First, these taxes are not always completely returned as a tax credit. Even if they are, however, the refund period is usually long, which influences both cash flow and the amount of income generated from an investment. Second, because the difficulties presented above, international holding companies often take the initiative to find AADTs that stipulate lower rates of withholding tax on passive income (Gajewski, 2017, p. 228). Conversely, in the case of the tax administrations of countries that are importers of capital, treaty shopping results in a considerable reduction of the tax base. Consequently, the tax authorities have an economic interest in withholding an appropriate amount of tax from income paid to nonresidents.

Moreover, the structure of this tax is based on one of the following systems: the refund system or the certification system.

The legal measures that prevent treaty shopping may also be included in agreements on the avoidance of double taxation. The process of economic globalization, along with the gradual abandonment of foreign exchange controls and other barriers to the free movement of capital, have made a substantial contribution to economic development. Conversely, the same factors have led to an increase in the possibilities of avoiding taxation, which results in decreased income to state budgets (Scholz, 2010, p. 88). Although the OECD has shown interest in the new phenomena emerging with respect to the movement of capital related to the activities of international holding companies, the organization has left these issues to be resolved by member countries that may regulate them favorably primarily by negotiating advantageous conditions to be stipulated in an AADT. The Commentary to the OECD Model Convention (MC) states that the chief objective of an AADT is to promote the exchange of goods and services and the movement of capital and services by eliminating double taxation. International holding companies, regardless of an AADT's stipulations, have the option to use not only the differences in tax rates applicable in particular states but also other tax advantages offered by tax regulations in particular countries (Panayi, 2007, p. 45). Member countries attempt to counter such holding company practices by using containing provisions in the concluded tax treaties, which stipulate that issues related to tax avoidance will be regulated by each state's national laws. The OECD does not claim that these issues should be exclusively regulated by national laws aimed at preventing double taxation, a solution that is already recognized in bilateral agreements. It must be clearly stated that considering the number and divergence of the OECD member countries, it is very difficult, if not impossible, to introduce effective legal measures against treaty shopping into the OECD MC.

Introducing legal measures (contract clauses) intended to prevent treaty shopping into bilateral agreements should be preceded by a detailed analysis of the circumstances and structures that create the urge to use the practice in question. The primary aim is to make treaty benefits exclusively available to the group of entities entitled to use them in line with the intention of a given bilateral agreement. It is thus recommended to examine the extent to which tax benefits may be achieved by conduit entities, the legal context of this phenomenon in both contracting countries, and the possible consequences of implementing new solutions for holding companies acting in good faith. Under the OECD MC, there are two fundamental legal measures that counter treaty shopping: limitation on residence status and determination of which entity is the beneficial owner.

With respect to limiting residence status, it is notable that in the case of all possible techniques of treaty shopping, including both the direct conduit and the stepping-stone methods, conduit entities established in one or several countries that are parties to tax treaties make it possible for taxpayers of third countries, who otherwise would not be included in the scope of an agreement, to obtain tax benefits. Tax optimization is based on the supposition that residents (e.g., undertakings that are part of a holding company) of the contracting states are entitled to the tax benefits of an international agreement (Avi-Yonah, 2009, p. 102). Therefore, if a conduit company may be treated as a resident of a contracting state consistent with its national law, it is also entitled to use the provisions of the tax treaty. However, in accordance with the OECD MC, each entity subject to a tax obligation in a given state that arises in connection with income generated from sources or capital located on that state's territory is excluded from the definition of "the resident of a contracting state", if that is the only basis for imposing a tax obligation. Nevertheless, the above-mentioned stipulation may not be interpreted in a broad sense because that would result in excluding from this definition of all residents of states that use the territorial principle in their national statutory laws (Weyzig, 2013, p. 23).

Thus, a strict interpretation of the law is indispensable because otherwise, the solution delineated above would be ineffective. The legal effect, however, is that according to general principles, a conduit company is perceived as a resident of the conduit country and therefore is entitled to use the treaty tax benefits, even if the actual recipient of income will not be eligible for privileged treatment under the bilateral agreement, namely, it will not use the agreement's tax benefits (Avi-Yonah, 2009, p. 104). Such a regulation may not be deemed satisfactory. This is why other measures that prevent the circumvention of an AADT are adopted. The most radical and universal method to counter treaty shopping is the practice of not concluding AADTs with tax havens: this is referred to as the abstinence approach. Nevertheless, such a solution is not always acceptable (for instance, due to provisions on exchange of information).

The OECD Model Convention limits right to use lower rates of withholding tax on dividends, interests, and royalty payments so that only the actual beneficiary of these incomes, i.e., the so-called beneficial owner, may use them. If a person establishes a conduit company to use the tax rates stipulated in a tax treaty, such an agreement excludes that person from the scope of the entities entitled to use the tax privileges because he or she is not the actual beneficiary of income. However, the notion of beneficial owner is not a legal term and thus its interpretation is not precise. Moreover, this term may not be used to refer to entities subject to the national law of the contracting states, especially considering that few systems of statutory law provide a definition (Endres, Schreiber, Dofmuller, 2006, p. 48). Most frequently, it is an agent or a proxy that acts as a conduit entity between the distributing party and the recipient of passive income. Accordingly, it should be held that in the (economic) situation described above, the entitlement to income should prevail over the formal entitlement. The tax consequence should be correlated with the substance of a legal act and not its legal form. However, one must remember that the source state must prove that the conduit entity performs only conduit functions and the scope of its authorization is narrow. This leads to the categorization of entities, which may be perceived as compromising the principle of equality of tax treatment. However, it is not easy to demonstrate that an entity that serves as an international holding company's financial center is merely a conduit, even if the primary reason for its existence is to use privileges arising from an AADT that are otherwise unachievable for an entity that is only a company shareholder. Clearly, the method presented above is insufficient to counteract treaty shopping, which is also true for the method of limiting residence status.

Alternative possibilities of countering international tax avoidance

Countering tax avoidance in the context of treaty shopping is exceptionally significant. The Commentary to the OECD Model Convention contains additional advice intended to help member countries address the issue of preventing international tax avoidance (by holding companies) achieved through treaty shopping. The following alternatives are available (Pistone, 2010, p. 420):

- the look-through approach;
- the limitation of benefits approach;
- the exclusion approach;
- the subject-to-tax approach; and
- the channel approach.

The look-through approach is concerned with the use of conduit companies and is aimed at countering treaty shopping committed by entities that are not subsidiaries of a state resident where those entities are also residents. According to the look-through approach, a company that is a resident of a state-party to an AADT should not be entitled to a tax credit under the agreement if it is owned by entities that are not residents of the state-party to the tax treaty. This method gives tax authorities the right to verify whether a company is used for tax-related purposes by shareholders whose place of residence offers no opportunity to use a treaty's tax benefits, i.e., when they are not de facto included in the scope of the agreement. If the agreement contains no other stipulations related to this issue, a tax authority may attempt to learn who is listed as a shareholder in the company records. Considering the fact that a person listed as a shareholder may not be the final recipient of dividend (i.e., the advanced look-through approach), tax treaties differentiate between the term "beneficial owner of shares" and "final recipient of dividend." The analyzed approach has one serious flaw-selectivity-which is manifested in ignoring the aspect of an economic entity's legal personality under certain circumstances (Weyzig, 2013, p. 10). In line with the look-through approach, the application of an AADT does not depend on a legal person's residence but instead on the residence of the final recipient of income.

The treaty-shopping-prevention instrument described above requires, however, that detailed criteria be applied to determine whether a given company is owned by nonresidents of a state-party to an agreement or whether it is controlled by that type of entity. Therefore, the look-through approach is not an easy method to adopt in situations that involve relationships between EU Member States. In such situations, for a definition of "control" to be comprehensible, it should consider two conditions: ownership of a specific percentage of shares in a company's capital and the possibility of influencing the selection of the majority of a company's board members (Mutti, Grubert, 2009, p. 120).

The look-through approach is similar in this respect to the limitation of benefits approach. Both of these anti-abuse measures prohibit the use of tax preferences provided in an AADT if a subsidiary's actual board is located in a tax haven and the holding company is also a tax resident of the haven (Gajewski, 2017, p. 233). When implementing the measures in question, states concluded that the provisions of AADTs may be used by so-called qualified entities or other persons meeting the specified criteria.

In some cases, it will also be possible to confer the right to use an AADT on an entity that may not gain the status of a qualified entity, if it conducts business activity in the state of residence (excluding certain types of registered activity, such as e.g., investment management) and if income generated in the source state maintains at least an incidental connection with activity conducted in the state of residence. Although in practice the usefulness of the look-through approach as a method for preventing treaty shopping is limited, it is recommended in the case of low-tax countries (tax havens) where usually no actual business activity is conducted. Most significantly, barriers to adopting this method generally arise out of practical difficulties in its application, which is connected to the method's incompatibility with the rules of trade law (Kraft, 2012, p. 33).

The method based on the exclusion approach is concerned with excluding the possibility for a holding company that could use the tax privileges offered in a given state to obtain treaty benefits in another way by establishing a conduit company exempt from taxation in that state on the condition that company's purpose is to benefit from a particular AADT. The ratio legis of this construction involves limiting treaty benefits in a situation in which conduit entities inappropriately use special tax privileges granted under national tax law applicable in a given state (e.g., exempt status) due to treaty shopping (Panayi, 2007, p. 45).

To adopt the method presented above, tests that determine the preferentiality of tax treatment within the overall tax system are implemented. Such tests are intended to ensure the effectiveness of the method in question, i.e., to prevent an entity from being eligible for a double tax advantage: first from national regulations and again under the provisions of an AADT. The preferentiality of a tax regime is shaped chiefly by the following conditions (Thuronyi, 2010, p. 451):

- no tax is imposed on income from a given source;
- income generated by a nonresident is taxed more advantageously than income generated by a resident; and
- income is subject to preferential tax treatment other than credit for taxes paid abroad.

If the result of a test demonstrates that a given tax regime offers advantageous, preferential tax treatment on the basis of national regulation, the possibility of being subject to preferential treatment under the provisions of an AADT should be denied. However, it must be noted that the application of the exclusion approach is limited and occasionally ineffective with respect to more sophisticated methods of abusing an AADT, which N.B., are more commonly employed by holding companies.

Another method referred to as the subject-to-tax approach consists of treaty benefits being granted in the source states only if income is subject to taxation in the taxpayer's state of residence. It is important, however, that benefits are effectively granted in only one country if income is subject to tax in another (Peralta, van Ypersele, 2006, p. 714). The method is adopted when income generated in a contracting state is received by a company with a registered office in another contracting state and simultaneously one or more persons nonresidents of the second state directly or indirectly possess (through one or more companies) considerable assets in this company either in the form of shares or in any other form (directly or indirectly), either alone or in cooperation with other persons who manage or control the company.

Nevertheless, it seems that this method has two serious flaws (Bernstein, 2007, p. 1212):

- it does not allow entities subject to certain tax preferences, which have been implemented for the purpose of stimulating economic development in a given country, to use the treaty benefits; and
- it does not prevent the adoption of sophisticated tax-avoidance methods, e.g., the stepping-stone method.

On the basis of the next method, the channel approach, a taxpayer that is a company with a registered office in the territory of a state-party to an AADT should not be entitled to treaty benefits if the following conditions are jointly observed: it receives income from the other contracting state; at least one person nonresident of the other state directly or indirectly possesses considerable company assets in the form of shares and exercises management or control of the company; and at least 50% of a company's income is employed to settle claims related to the above-mentioned person on account of, e.g., interest. This method is used for companies that pay a majority of their total income to entities that are not residents of a state-party to a tax treaty.

Those who criticize this method stress that its application may lead to administrative difficulties and express their doubt as to whether it may be efficiently adopted.

The methods presented above largely prevent tax avoidance through treaty shopping in violation of an AADT's provisions. It is worth noting, however, that legal regulations of the same type may limit the application of treaty tax benefits with respect to economic transactions made in good faith by international holding companies (Ihori, Yang, 2009, p. 215). Therefore, it also seems worthwhile to note tax-treaty provisions guaranteeing that the above-mentioned legal measures for countering treaty shopping will not infringe the rights of entities that may obtain treaty benefits legitimately.

Conclusions

Countering tax avoidance within the framework of treaty shopping is complex and multidimensional. Undoubtedly, it is theoretically possible to counter the abusive practice of treaty shopping both on the level of particular AADTs and on the level of particular states' tax laws. However, no general rule exists that would allow the questioning of an entity's entitlement to use treaty provisions and in each case, deprivation of the right to use treaty benefits must be based on a specific legal rule derived either from the provisions stipulated in the agreement itself or from the national tax law of the interested country.

To summarize the issue revolving around the phenomenon of treaty shopping, it must be stated that although various measures for countering this type of tax avoidance are being implemented, action against treaty shopping is hindered because many states have entered into agreements with tax havens related to the avoidance of double taxation. The simplest solution would be to not conclude such agreements (Wacker, 1993, p. 385). However, this is not possible because such agreements are often a consequence of economic and political ties between states and from occasionally, they also have historical roots.

A vast number of countries and international organizations have taken action against using agreements to avoid double taxation. Among other things, it is frequently recommended to avoid adopting new tax conventions and instead to renegotiate and terminate former agreements that allow third countries to receive tax benefits from them. However, due to the large number and variety of tax systems, it is not possible to develop a universal contract clause that would limit access to tax benefits (Sørensen, 2004, p. 1202). Particular tax relationships must be considered individually, and the current system of withholding taxation calls for modification.

Countering treaty shopping is very frequently ineffective because an inappropriate method of fighting this phenomenon has been adopted. It is often the case that selection of such a method does not take into consideration the environment and conditions under which treaty shopping occurs.

In general, until now tax authorities in the interested countries have not developed any successful method to counter treaty shopping. Instruments intended to prevent this practice are frequently ineffective because international holding companies can easily circumvent them. Prevention may only be achieved by holding companies engaged in cross-border business activity because legislators cannot create "hermetical" regulations that would secure their countries against treaty shopping that leads to harmful tax avoidance.

It has been proved that laws against treaty shopping are often unsuccessful and ineffective. This is because on the one hand, such laws constitute a response to the existing phenomenon of tax avoidance and on the other hand, due to a precisely defined scope of regulation, it is usually possible to avoid the obligations arising from the provisions of such laws.

Clearly, legal regulations to counter tax avoidance are formulated differently in the statutes of various EU Member States. There are often discrepancies among the very fundamentals of such statutes, which sometimes are merely concerned with inconsistencies in defining the key terminology. Such differences make it possible for international holding companies to favorably optimize taxation by "shifting" among tax jurisdictions that are especially advantageous in terms of taxation. Thus, holding companies operating within the entire EU pay particular attention to selecting countries in which they will use the provisions on tax avoidance.

To recap the issues delineated above, it must be stated that treaty shopping constitutes a significant element of an international holding company's tax-optimization policies; however, methods for countering treaty shopping are also important. Analysis of those methods permits conclusions that convincingly demonstrate that their thorough knowledge enables holding companies to use them to avoid taxation through successfully and profitably adopting the instrument of treaty shopping.

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Dr hab. Dominik Jan Gajewski, prof. SGH

Habilitated Doctor of Laws, professor at the Warsaw School of Economics (SGH), Head of the Chair of Tax Law at SGH; Head of the SGH Centre for Analyses and Studies of Taxation; Head of the Economic Analyses Team at the Case Law Office of the Supreme Administrative Court; judge at the Supreme Administrative Court; Member of the Council for Countering Tax Avoidance reporting to the Minister of Finance; Chief Editor of a scientific journal Analyses and Studies CASP; author of over 190 peer-reviewed scientific publications (including seven monographs) concerned with international and national tax law; Head of a post-graduate course at SGH in Taxes in National and International Business Trading.

Dr hab. Dominik Jan Gajewski, prof. SGH

Kierownik Zakładu Prawa Podatkowego Szkoły Głównej Handlowej w Warszawie; kierownik Centrum Analiz i Studiów Podatkowych SGH; kierownik Zespołu Analiz Ekonomicznych w Biurze Orzecznictwa NSA; sędzia Naczelnego Sądu Administracyjnego; redaktor naczelny czasopisma naukowego „Analizy i Studia CASP"; autor ponad 200 recenzowanych publikacji naukowych (w tym siedmiu monografii) z zakresu międzynarodowego i krajowego prawa podatkowego; kierownik Studiów Podyplomowych SGH — Podatki w krajowym i międzynarodowym obrocie gospodarczym.