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FEATURED PERSPECTIVE

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In this article, the author uses Inditex as a case study to facilitate a discussion of country-by-country reporting and look at disagreements regarding the meaning of "aggressive avoidance."

Starting this year, large multinational companies will file their first country-by-country reports with information on sales, profits, number of employees, and taxes paid for their entities in each jurisdiction where they operate. Businesses are also increasingly recognizing that tax is a reputational issue and making policy commitments to that effect. These include promises to pay tax where value is created, ensure their structure is aligned with commercial functions, and refrain from creating contrived or artificial transactions. However, criticisms and exposés of alleged tax avoidance continue to make headlines.

Many civil society organizations, including Eurodad, Transparency International (EU), Action Aid, Christian Aid, Oxfam, the Tax Justice Network, and the Financial Transparency Coalition, as well as some politicians and the European Commission argue that the solution is for companies to publish CbC information publicly, so that citizens can see for themselves what tax multinationals pay. They hope that putting these numbers in the public domain will lead to more informed debate and enhance democratic accountability, ultimately improving effectiveness and trust in the tax system. The commission argues that public CbC reporting would deter companies from "engaging in tax planning strategies that are not in line with their corporate responsibilities and which consumers, investors and broader civil society find unacceptable."[1]

On the other hand, some tax professionals fear that public CbC reporting would lead to a cacophony of accusations, misunderstandings, and rebuttals — fueling further public mistrust.[2] They argue that revenue authorities determine tax bills using voluminous rules and detailed tax returns submitted confidentially. They contend that a few headline indicators are inadequate to allow members of the public to second-guess the basis of these calculations.

This is not a debate that must remain purely hypothetical. Companies in the extractive industries and the financial sector are already required to report key information on a CbC basis. Others such as Telefónica and Vodafone make enhanced disclosures of their tax payments and national operations. For multinationals that operate primarily in Europe, much of the information is already in the public domain, albeit scattered among the accounts filed by subsidiaries in different jurisdictions. While this stops short of meeting demands for public CbC reporting, it is sufficient to enable a more practical conversation about how the information

[1]European Commission Staff Working Document, Impact Assessment Assessing the Potential for Further Transparency on Income Tax Information, SWD(2016) 117 final (Apr. 12, 2016), at 13.

[2]*See* Andrew Goodall, "Public CbC Reporting Won't Improve Public Confidence, Practitioners Say," *Tax Notes Int'l*, Jan. 9, 2017, p. 164.

might be interpreted and against what standards, principles, or benchmarks corporate tax behavior could be judged.

This article looks at the case of the Spanish fashion retailer Inditex, which has long faced criticism[3] from campaigners calling it a tax dodger. It demonstrates that the disagreement between the company and the campaigners has very little to do with trying to deduce profit-shifting behavior from CbC information, but rather reflects a more fundamental disagreement about what is meant by ''tax avoidance.''

Inditex

Inditex is better known by its designer fashion brands, such as Zara, Massimo Dutti, and Pull and Bear.[4] Headquartered in Spain, the group is one of the world's biggest fashion companies. As the company highlights in its 2015 annual report, Inditex has more than 7,000 stores in more than 90 countries, sells almost a billion garments a year across 50,000 different product lines, and operates e-commerce services in 29 markets. Inditex sold around €21 billion in products in 2015 and made €3.7 billion in profits before tax, paying €0.86 billion in income tax (23 percent). It stands out as one of the clothing companies with the highest profit margins in the sector, at around 17 percent.

Each of the group's brands has a different style and identity, and they operate their own separate chains of retail outlets. However, a common set of central services underpins all the brands, including in-house design operations and tightly coordinated supply chains that are critical to the Inditex model of rapidly refreshing small runs of stock based on sales.

The company has around 150,000 staff, of which 87 percent work in stores, 7 percent in central services (finance, management, design, sourcing, and so forth), 5 percent in logistics, and 1 percent in manufacturing. Half of the central services workforce are in Spain, half in other countries. The group that manages relationships with 12,000 suppliers is based in Switzerland. Subsidiaries in Ireland manage intercompany loans and insurance, as well as aspects of e-commerce. ITX Merken BV (branding) in the Netherlands manages the look and layout of stores.

[3]''Fashion Retailer's Tax Dodges Boost European Inequality,'' Tax Justice Network, Feb. 26, 2014.

[4]Zara is used as an example in this article, but the principles could apply equally to the other brands in the group. Figures throughout refer to the Inditex group and its subsidiaries, and are either drawn from the Greens-European Foreign Alliance (Greens/EFA) report or Inditex 2015 Annual Report. *See* ''Tax Shopping: Exploring Zara's Tax Avoidance Business,'' Aug. 8, 2016; and Inditex SA, ''Annual Report 2015,'' *available at* https://goo.gl/7JI8x2.

'Aggressive Avoidance' and Inditex

A recent report published by the Greens-European Foreign Alliance group (Greens/EFA) in the European Parliament compiled information from 60 sets of accounts filed by Inditex group subsidiaries and concluded that the company ''has saved at least €585 million in taxes during the period 2011-2014, by using aggressive corporate tax avoidance techniques.'' Inditex says its corporate tax bill was €4.4 billion for that period, so this represents 13 percent of what they paid. Inditex disputes the accusation of tax dodging, saying the report is ''based on erroneous premises that lead it to mistaken conclusions.''[5]

The Greens/EFA highlight what it sees as ''aggressive corporate tax avoidance techniques'' through Inditex's Dutch, Irish, and Swiss subsidiaries, as detailed in Table 1.

Branding, Sourcing, and E-Commerce

The Greens/EFA report says that ITX Merken, the Dutch subsidiary that franchises the store formula and brand to group companies, joint ventures, and concessions, is the key to understanding ''the ITX tax avoidance structure.'' It calculates that Inditex saved €295 million compared with what it would have paid if it had located the branding operation in higher-taxed Spain and €84 million more by amortizing the cost of licensing the brand to the Netherlands. Further, the Greens/EFA estimate that Spain, Italy, France, and five other countries lost €445 million in ''missing tax'' because of the royalties the retail stores pay on sales. The report defines ''missing tax'' as the amount of taxes that could have been paid if the whole amount of royalties had instead been treated as profit in the origin country.

Similarly the report concludes that the Irish e-commerce operation has saved ITX €30 million in taxes (compared with if it were based in Spain), and that running the sourcing operation from Switzerland results in an ''undetermined amount of tax avoidance.''

The situations that the report describes do not seem to fit within the everyday meaning of ''aggressive avoidance.'' While branding, sourcing, and e-commerce hubs *can* be used to shift profits from one place to another, they are also core commercial operations that enable Inditex to operate its shops and websites. They have to be somewhere, and the Netherlands, Ireland, and Switzerland are legitimate places to do business. The authors of the report, on the other hand, view Inditex's decision to locate these high-value business activities in relatively low-tax jurisdictions as ''aggressive avoidance.''

[5]''Inditex's Response to 'Tax Shopping: Exploring Zara's Tax Avoidance Business' Report,'' Aug. 12, 2016.

Table 1. Summary of the Greens/EFA Report Findings on Inditex

Report Chapter	Business Structure	Details	How Much Avoided?
''Going Dutch: Shifting Profits Through Royalty Payments''	**ITX Merken BV** — Dutch branding subsidiary. 203 staff. Profit margin 45%. Effective tax rate 15%.	Inditex's retail subsidiaries pay a royalty (assumed to be 5% of sales) to ITX Merken, a subsidiary in the Netherlands, as a license for the store format and fit out.	€378 million compared with if the subsidiary was in Spain. In addition €445.2 million of ''missing taxes'' from retail countries such as France, Germany, and the U.K.
''The Irish Case — Lower and Lower Taxes''	**ITX Fashion** — Irish subsidiary. 21 staff. Profit margin 15%.	ITX Fashion manages e-commerce outside of Europe.	€30 million compared with if the subsidiary was in Spain.
	ITX RE — Irish captive insurance company.	ITX RE provides internal insurance to Inditex companies.	€12 million compared with if the subsidiary was in Spain.
	Zara Financiën — Dutch company, tax resident in Ireland.	Main purpose is to receive interests on a loan given to a group company in the Netherlands.	€17 million compared with if the subsidiary was in Spain.
''Sweet Switzerland: Opaque Structures in the Alps''	**ITX Trading**	Role is to distribute and trade textiles and apparel products.	''The first point of tax avoidance,'' ''amount not determined.''
	ITX Holding — Swiss holding company, net income assumed to be €620 million.	Owns ITX trading, as well as the Dutch and Irish finance companies.	€149 million compared with if the holding company was in Spain.

The large numbers cited in the report are a consequence of this definition. The report also ignores the €360 million in tax that Inditex says it paid in Spain when the branding rights were sold to the Netherlands company.

Finance and Holding Companies

According to the Greens/EFA report, the second largest category of ''aggressive avoidance'' committed by Inditex involves the Swiss holding company that collects dividends from other financing and trading companies in Switzerland, the Netherlands, and Ireland. This holding company paid out dividends of €620 million to its Dutch parent between 2012 and 2014. Switzerland levies minimal taxes on holding companies.

However, this is not unusual. For example, Spain also has a holding company regime. The principle of a company paying tax where it creates value does not conflict with it using tax-neutral holding companies to passively collect and distribute revenues among the group. The report nevertheless labels this ''aggressive avoidance'' and says the company avoided paying €149 million in tax compared with what it would have owed if this structure were in Spain.

ITX RE is a captive insurance company located in Ireland. Most large multinationals have similar operations. Their commercial rationale is save money and retain capital compared with the cost of a third-party insurer. However, these structures also raise the possibility of avoidance if risks are not transferred between parts of the business at a commercial rate. This can be difficult to assess, but (as with branding, sourcing, and e-commerce) the Greens/EFA report defines merely choosing to locate this part of the business in Ireland as tax avoidance.

Zara Financiën *does* seem to be a tax-motivated structure. It is a Dutch company managed in Ireland, suggesting it seeks to take advantage of the tax treaty between the Netherlands and Ireland to convert interest income from the Netherlands into dividend income for the group. This structure may have been rendered obsolete by changes to the EU parent-subsidiary directive that became effective in 2016. If not, the anti-hybrid rules coming into operation in 2019 will prevent its continued operation.

Are Profit Per Margins and Per Head Useful?

The Greens/EFA report also compares profit margins and profits per head between different parts of the business. The Dutch brand subsidiary ITX Merken declares €2.4 million of profits per employee, while the ITX group overall makes only €18,000 per employee. Similarly, the report suggests that the Irish e-commerce subsidiary has much higher profits per employee than retail operations.

However, it is not obvious that these ratios offer a way to assess whether Inditex is profit shifting. Should central services and individual retail operations be expected to be equally profitable? Should the same

Table 2. Partial Country-by-Country Report Compiled on Inditex

	Sales (millions)	Employees (2015)	Profits Before Tax (millions)	Margin
Italy	3,607	6,306	188	5%
France	4,542	7,945	350	8%
Germany	2025	5,271	66	3%
Greece	1,503	3,471	39	3%
Austria	454	1,358	33	7%
U.K.	£2,059	5,271	£161	8%
Belgium	1,062	5,227	99	9%

Note: Figures are in euros unless noted otherwise.

amount of profit be associated with one senior manger influencing decisions on where new stores are located as with one sales associate in a single store? There is no clearly right ratio in each case.

There *is* a more meaningful assessment that provides something of a sniff test on the division of profits between retail operations and central services — the profitability of the retail operations. If Inditex is stripping profits from its retail stores, we would expect them to have very low margins compared with other retailers.

Table 2 was constructed using data from the Greens/EFA report. The profit margin of retail operations in Belgium, the U.K., France, and Austria are in the 7-9 percent band. This is not particularly low compared with stand-alone fashion retailers. Italy, Germany, and Greece have lower margins (between 3 and 5 percent), but there could be commercial reasons for this including the Greek economic crisis. Notably, Germany seems to have a low level of sales per employee.

Of course, much more detailed figures than these will have been considered by local tax authorities assessing whether profits are being shifted out of retail locations. Still, data akin to that in a CbC report do not seem to reveal glaring evidence of profit shifting.

What Does 'Aggressive Avoidance' Mean?

Sourcing, store branding, e-commerce, and finance are commercial functions in a complex vertically integrated business. While it is clear that the tax environment was a factor encouraging Inditex to choose its locations, only the Dutch-Irish financing company appears to be more focused on tax optimization than the business of fast fashion, but it contributes only €17 million out of the headline total of €585 million (around 3 percent).

Internal transactions *do* open up opportunities for profit shifting, but they are subject to scrutiny by revenue authorities and audited against rules on antiavoidance, transfer pricing, thin capitalization, and controlled foreign corporations, using much more detailed information than would be available in a CbC report.

The Inditex case does not appear to be close to the frontier of legally questionable tax behavior, or to breaking with principles such as paying tax where value is created and aligning structures with commercial functions. Instead, it highlights quite a different yardstick — one that suggests that a company choosing to locate high-profit activities in relatively low-tax countries when they could have been located somewhere else is by definition practicing ''aggressive avoidance.''

Ratios and Ratings

Beyond individual company analysis, some have suggested that CbC information could be used to construct cross-company comparisons based on ratios like profit margin per employee or profits per employee. The European Commission says that these formulary apportionment ratios could be used as a benchmark for public assessment of companies based on CbC reports. There have been a few studies that seek to develop this approach. In 2015 the Greens/EFA group published a review of CbC reporting by banks comparing the reported basis of profit allocation with the profit allocation using various formulas involving factors like turnover and number of employees.

However, the Inditex case highlights the problem with this type of calculation — they rest on the assumption that a complex international business should have the same ratio of profits to turnover, employees, and tangible assets in all parts of its operation. This jars with commercial reality. For a company like Inditex, when the vast majority of staff work in retail locations but value is also created by other operations (including design, sourcing, logistics, branding, and finance teams), anything more than minimal profits attributed to these central services could be interpreted as profit shifting under these calculations. Similarly, taking the example of banks, there is no reason to expect that entities that include major metropolitan branches, online banking, investment banking, and other operations will have single, standard ratios between profits, turnover, and staffing across all these groups.

Applying these methods to CbC data and ranking individual companies on the extent of misalignment is likely to penalize technology- and innovation-intensive companies and sectors. At the same time, it may fail to effectively distinguish substantial commercial activities and arm's-length pricing from arrangements that could be judged as unacceptable, artificial, or aggressive.

This is also a challenge for high-level efforts to estimate the magnitude of base erosion and profit shifting. Many of the structures highlighted in the Greens/EFA report, though they fall outside the definition of BEPS, *are* likely to be captured in cross-company measurements of BEPS. For example, Alex Cobham and Petr Jansky's working paper ''Measuring Misalignment''[6] constructs a measure of profit shifting using a formula based on tangible assets, sales, and employment.

Similarly, the OECD's estimate that BEPS results in revenue losses of around 4 to 10 percent of corporate income tax is based on a recently published study that uses total assets and employment as proxies for ''true activity.''[7] The study recognizes that this method will also capture non-BEPS behaviors such as carrying out substantial activity in a country in compliance with the arm's-length principle. The *Inditex* case highlights that this can be significant.

More Data or More Dialogue?

Pierre Moscovici dubbed the Inditex story #ZaraLeaks, although that may be semantic overreaching since there was no actual leak involved. Rather, the underlying data came from corporate accounts filed with the company registrar in several jurisdictions. Moscovici argues that the situation exemplifies the need for ''a further call for more fiscal transparency.'' But, in fact, what this case seems to demonstrate is not so much a deficit of data, but a deficit of discussion.

There is broad agreement that companies should not practice ''aggressive avoidance,'' but little clarity in the public debate about what that means. For example, there is no consensus about whether it is unethical for a company to pay royalties to a Dutch subsidiary, locate its e-commerce activity in Ireland, or run its sourcing operations out of Switzerland. The calculations in the Greens/EFA report reflect a much broader interpretation of ''aggressive avoidance'' than that used by many tax professionals, revenue officials, legislators, and even some civil society organizations. The party's reply[8] to Inditex's response makes clear that the core argument of aggressive avoidance is that the company reports lower profits associated with retail activities than it does with non-retail activities in Ireland, the Netherlands, and Switzerland. The reply explains, ''Unfortunately, corporate tax avoidance is legal and this is why the Greens/EFA Group campaigns to change the European legislation.''

Similarly, there is broad agreement with the principle that governments should close tax loopholes and that companies should not exploit them. Yet only 3 percent of the headline amount in the Greens/EFA report on Inditex appears to be associated with anything resembling a loophole. Even that loophole could be easily closed by the Netherlands and Ireland adopting the OECD double tax treaty. Indeed, it may have already been closed by developments at the EU level.

Business leaders, tax professionals, and organizations representing a range of interests continue to talk past each other, contributing to the public growing ever-more cynical (and ever more confused). Data alone may not solve the problem. It is not clear whether the disputed information would allow stakeholders to assess whether a particular company has stepped over the line or, conversely, allow companies to defend their reputations through transparency. However, a careful examination of specific case examples can provide an opportunity to test the hopes and fears about CbC reporting. Case studies may also allow interested parties to explore the expectations and the boundaries of responsible tax practice. ◆

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[6]Alex Cobham and Petr Jansky, ''Measuring Misalignment: The Location of US Multinationals' Economic Activity Versus the Location of Their Profits,'' International Centre for Tax and Development Working Paper 42 (Nov. 2015).

[7]Åsa Johansson, Øystein Bieltvedt Skeie, Stéphane Sorbe, and Carlo Menon, ''Tax Planning by Multinational Firms: Firm-Level Evidence From a Cross-Country Database,'' OECD Economics Department Working Paper No. 1355 (2016).

[8]''Greens/EFA Comments to Inditex's Response on the 'Tax Shopping' Report'' (undated).