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Tax policy in the EU

Issues and challenges

IN-DEPTH ANALYSIS

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This publication presents the main issues and challenges relevant to tax policy in the European Union. It illustrates a number of recent actions and deliberations in the tax field, but does not aim to provide an exhaustive catalogue of taxation measures. It also sets out a range of references on EU taxation provisions and literature.

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EXECUTIVE SUMMARY

The current EU taxation framework leaves Member States free to decide on their tax systems provided they comply with European Union (EU) rules. Those rules are adopted unanimously by the Council. The development of EU tax provisions is linked with the completion and proper functioning of the single market, with indirect taxes addressed earlier and more in-depth than direct taxes.

Taxation provides revenues for national budgets emanating from national taxes, local taxes and social contributions which are levied on consumption, labour or capital. Taxes have complex impacts and as such have consequences for multiple policies, mainly applied in the EU context to support the proper functioning of the single market. For example, in competition policy, state aid provisions also apply to direct business taxation.

National tax systems face stronger competition as a result of the globalisation of the economy. Tax competition favours certain taxpayers to the detriment of others, and the same holds true for Member States when they compete on taxation to attract economic activity or tax revenue. Digitalisation creates new business models and affects the economy as a whole. Globalisation and digitalisation both trigger a need to update and adapt tax systems. They offer the opportunity to modernise tax systems generally considered as complex and consequently having the side effect of creating undesirable potential for avoidance and evasion. This contradicts the overriding objective to set favourable conditions for growth and equity.

In the context of consolidation of public finance, tax policy is used to provide budget revenues and to frame social and economic policies. Tax restructuring must serve to stimulate growth, in particular by altering the way the tax burden is split between labour and consumption, and preferring tax-base broadening over raising tax rates.

In keeping with the aim of making taxation fair, effective and conducive to growth, tax systems face the challenge of improving tax compliance, which will contribute to recuperating lost resources. Fighting tax evasion and tax fraud, and the related opacity and secrecy, requires actions at EU and international level. These aim to increase transparency, which can contribute to reducing the available space for such behaviour. In particular, enhanced exchange of information constitutes a step forward in fighting against tax fraud and evasion.

Tackling harmful tax competition and aggressive tax planning is a major aim of cooperation at EU level, in particular in business taxation, where the objective is to reduce the number of loopholes stemming from the complex array of rules, assessment bases and rates which may apply to a single firm. Cooperation is also developing in the international arena, in particular through OECD work on taxation in conjunction with the G20.

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List of main acronyms used

AEOI: automatic exchange of information

BEPS: base erosion profit shifting

CCCTB: common consolidated corporate tax base

CIP: corporate income tax

ECOFIN: Economic and Financial Affairs Council

ESA95: European System of Accounts 1995

FTT: financial transaction tax

OECD: Organisation for Economic Co-operation and Development

PIT: personal income tax

PSD: parent subsidiary directive

SSC: Social Security Contributions

TAXUD: Directorate-General for Taxation and Customs

VAT: value added tax

1. Introduction

Profound changes in tax systems have resulted from globalisation and digitalisation of the economy, which has substantially increased geographical tax mobility. Accordingly, competition has also developed between tax systems, raising concerns for a level playing field and fairness in global tax policy.

Tax policy has moved up the agenda in connection with the financial and economic crisis, which compelled European Union (EU) Member States to raise taxes rapidly to find tax revenues for financing spending, while reducing budget deficits and consolidating public finances. The fight against tax evasion, fraud and avoidance has also been placed high on the EU and national agendas, since their goal is not only to recover unpaid revenue from taxation, but also to strengthen fiscal justice, benefiting both public budgets and taxpayers in the EU.

Tax policy is to contribute to meeting the current economic and social challenges, in particular to stimulate growth, economic and monetary. To this end, the mission letter[1] to Commissioner Pierre Moscovici, in charge of taxation policy, specifically underlines the importance of tax systems:

> 'While recognising the competence of Member States, the modernisation of tax systems is essential for delivering on the priorities of the European Semester of economic policy coordination. Reforms should involve promoting a broadening of the tax base, shifting the tax burden away from labour, improving tax compliance and addressing the debt bias in corporate and personal income taxation. All efforts should also be made to combat tax evasion and tax fraud.'

Tax policy is at a crossroads: it remains a national matter, but requires increasing cooperation and coordination at EU and international level to address specific issues and challenges.

2. Taxation in the EU

2.1. Taxation in perspective

2.1.1. How the EU has been involved in tax matters

Tax matters have been included in the Treaties since the Union's beginnings. Nevertheless, they have remained closely linked to Member State sovereignty (along with police and military issues), protected by the unanimity requirement and a special legislative procedure which keeps tax matters firmly under the Council's control.

At the same time, the EU Treaties (and previously the Economic European Community – EEC – Treaty and the European Community – EC – Treaty) have specifically addressed the need for harmonisation of domestic provisions on indirect taxation (turnover tax and value added tax – VAT – excise duties and other indirect taxes) because of their potential distorting effect on the single market. Harmonisation of all major elements of

[1] Mission letter from Commission President Jean-Claude Juncker, dated 10 September 2014.

value added taxation dates back to 1967,[2] and harmonisation of excise duties[3] to the early 1970s.

Harmonisation of these is far more advanced than in the case of direct taxes, which are not mentioned in the treaties. However, the founding principles of the single market (in particular free movement of services and non-discrimination) have brought direct taxes into the EU remit through the trade-off between national tax provisions and the single market. The Court of Justice of the European Union (CJEU)[4] has had to decide on articulation between national tax provisions and single market, and in several cases it overruled such national tax provisions. Direct taxes are addressed in particular through the focus on the removal of tax obstacles and the prevention of tax competition.

2.1.2. Main EU provisions relevant to tax policy

Apart from specific tax provisions, a number of the provisions and principles of general application in EU Treaties are relevant to tax matters.

Tax provisions chapter (Articles 110 to 113) of the Treaty on the Functioning of the European Union (TFEU), specifically provides for 'the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and functioning of the internal market and to avoid distortion of competition'. It also maintains a special legislative procedure whereby Council acts unanimously and the European Parliament is only consulted.

The chapter on the **approximation of laws** (Articles 114-118 TFEU) covers taxes which have an indirect effect on the establishment and functioning of the internal market, with fiscal provisions not subject to the application of the ordinary legislative procedure. In addition, tax harmonisation can be realised through directives only, according to Article 115 TFEU.

Other relevant provisions are the **free movement** of persons, services and capital (Articles 45-48 TFEU for workers, 49-55 for the right of establishment, 56-62 for services and 63-66 for capital and payments). **Environment** provisions (Articles 191-192 TFEU) also include tax components. **Competition** provisions, in particular the prohibition of state aid enshrined in Articles 107 to 109 TFEU, are relevant to tax policy.

General principles of particular relevance in tax matters are: non-discrimination, proportionality, legal certainty or unjust enrichment. The principle of Union loyalty provided for by Article 4(3) TFEU contributes to ensuring the effectiveness and equivalence of EU tax provisions for EU citizens. It also serves to clarify the precise obligations of Member States when the Treaty itself does not do so. In particular, rights deriving from EU law must be equivalent to those governing equivalent national situations, and national tax cannot render the exercise of rights derived from EU law excessively difficult, or almost impossible.

Enhanced cooperation (Articles 326 to 334 TFEU) can be used in tax matters.

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2 Turnover taxes were covered by EC provisions as early as 1967 (multi-stage but non-cumulative turnover tax, Council Directive 67/557/EC), and a common system of value added taxes was set up with the 6th directive (Council Directive 77/388/EEC), recast in 2006 (Directive 2006/112/EC).

3 See DG TAXUD web page on excise duties.

4 For an in-depth presentation of EU Court case-law on direct taxes see the 2011 Study from the Policy Department publication 'The impact of the rulings of the European Court of Justice in the area of direct taxation 2010 : study'.

Territorial aspects

Territorial **scope** is defined in the treaties (in particular relating to dependent, overseas and associated territories) and specific secondary legislation instruments;[5] this is the case for VAT.

Another aspect is the determination of the **location of a taxable activity** (for instance a transaction between two parties in two Member States can be realised in another Member State). This is of particular importance since tax matters are not, or not fully, harmonised and national provisions can vary substantially (including differences in rates).

2.1.3. Actors and acts in tax policy

The framework applicable to tax policy is the following: the Member States are free to choose the tax system they consider most appropriate and according to their preferences, provided that they comply with EU rules. In addition, any proposal for EU action in the tax field needs to take account of the principles of subsidiarity and proportionality.

The main feature of EU tax provisions with regard to the adoption of acts is the fact that the Council decides on a Commission proposal by unanimity, with the EP only being consulted. Provisions adopted in the tax field include directives approximating national provisions and decisions of the Council. In addition to these provisions, implementing and delegated acts (regulations, directives or decisions) are adopted by the Commission when the basic act provides for this.

Adding to these legally binding acts, non-legally binding instruments (soft law) provide a common approach, via recommendations, codes of conduct (business taxation), action plans and guides or explanatory notes providing practical and informal guidance about EU law and specifications.

2.1.4. Direct and indirect taxes

Direct taxation describes taxes that are levied on income, wealth and capital, whether personal or corporate.

As for personal income tax (PIT), freedom of movement of persons and the prohibition of discrimination implies that in the collection of direct taxes by a Member State, a worker who is a national of another Member State cannot be treated less favourably than its own nationals. PIT is not covered as such by EU provisions; it remains covered by bilateral tax treaties and the development of EU activity in this field is linked to CJEU case law.

EU action on company taxation is more developed, although it focuses only on measures linked with the single market principles. Wider reflections have been undertaken on several occasions, resulting in the development of important single market measures (Mergers and Parent-Subsidiary Directives, and more recently the proposed common consolidated corporate tax base).

Indirect taxation comprises taxes that are not levied on income or property. It includes VAT, excise duties, import levies and energy and other environmental taxes. The fundamental principle in international taxation is that indirect taxes on consumption are charged in the country in which the goods and services are consumed. For VAT, such a system was not possible and transitional VAT arrangements were adopted.

5 For instance, for VAT, Articles 6 & 7 directive 2006/112/EC.

Basically,[6] for sales to private persons an origin-based system is applied, whereas for taxation between taxable persons a destination-based system applies. In the latter case, the cross-border movement of goods is split into two different transactions: an intra-EU exempt supply which is exempted from VAT, and an intra-EU acquisition which is VAT-taxed in the country of destination. These transitional arrangements continue to apply, although they are generally found to be complex and to have significant compliance costs, as well as generating room for fraud linked to the possibility to buy goods free of VAT (carousel fraud), and for a collection gap ('VAT gap').[7] For the time being, the change to a definitive VAT system operating within the EU in the same way as it would in a single country is not yet politically achievable, as reported in October 2014.[8]

Excises apply to tobacco, alcohol products and cigarettes. Excise duties are specific taxes partially harmonised across the EU in the form of a monetary amount per quantity of product, and this does not vary dependent on the retail price.

2.2. Taxation in the economy

In order to give a global picture of taxes in the economy a selection of statistical data for EU levels is presented below.[9] Most indicators used reflect changes in legislation or economic activity only once they have delivered their impact.

Tax policy generates revenue for use by national governments. Tax revenues (including social contributions) account for the main share of government revenue: 90% of collective government revenue. The tax revenue of the EU institutions accounted for 0.7% of EU tax revenue.[10]

2.2.1. Tax-GDP ratio

Evolution in the tax-GDP ratio reflects changes in economic activity (employment, sales and services) and in tax legislation (rates, tax bases, threshold exemptions) affecting revenues as well as changes in the level of gross domestic product (GDP).

At EU level, as a weighted average, taxes (including social contributions) account for 39.4% of GDP (EU 28, 2012). That share has increased since 2009 which reflects pro-active measures taken by Member States in recent years to correct their government deficits. It can also be partly attributed to active revenue-raising measures in some Member States.

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6 There are some exceptions.

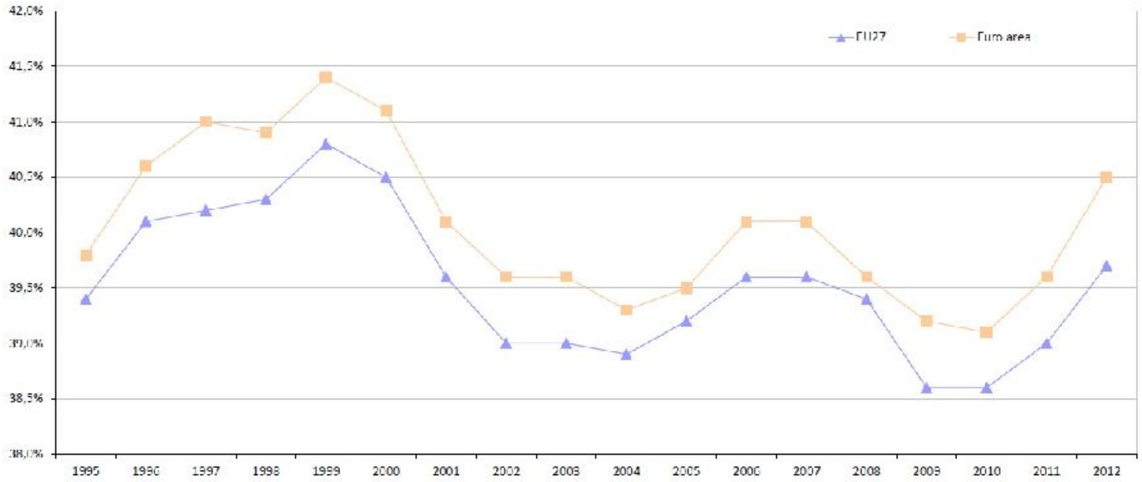
7 See for instance: 'Laundering the proceeds of vat carousel fraud' Financial Action Task Force (FATF-GAFI), 23 February 2007 and on VAT gap 2012 Update Report to the Study to quantify and analyse the VAT Gap in the EU-27 Member States, 22 October 2014.

8 Recent presentation of the state of play can be found in Commission document dated 29 October 2014 29.10.2014 SWD(2014) 338 final 'on the implementation of the definitive VAT regime for intra-EU trade'

9 For more see Taxation trends in the European Union, Eurostat, June 2014, including national data.

10 Statistics in focus 4/2014

Figure1: Ratio of tax as % of GDP – evolution over the past two decades



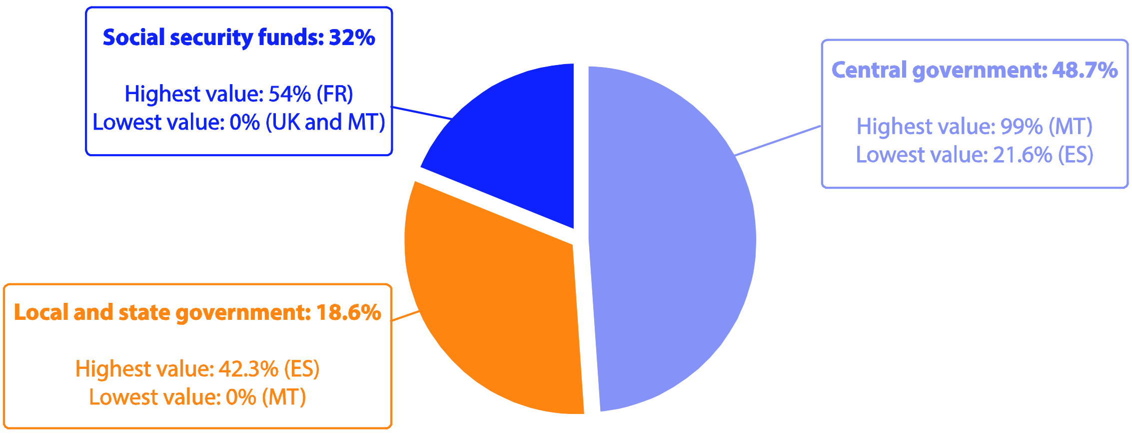
Source: *Eurostat* 2014

The ratio also varies from country to country, ranging between 48.1% (Denmark) and 27.9% (Latvia). The average EU ratio of 39.4% is higher than in other economies; the USA and Japan, for instance.

2.2.2. National taxes, local taxes and social contributions

As regards the **source** of tax receipts (EU average), the lion's share is accounted for by national taxes (almost half, 48.7%), a little less than a third (32%) by social security schemes and the rest (18.6%) by local taxes.

Figure 2: Revenue structure by level of government (% of total tax burden) 2012



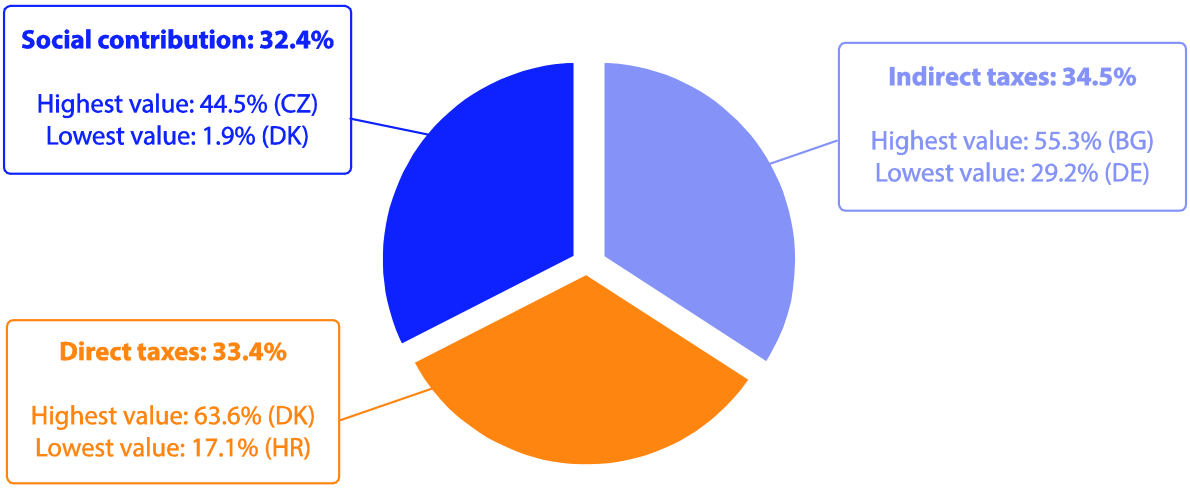
Source: Taxation trends in the European Union (2014).

However, these averages conceal very wide disparities between individual Member States: whereas in some, national taxes account for almost all or at least two thirds of tax receipts (99% in Malta, 94.3% in the United Kingdom and 66.2% in Portugal), in others it accounts for less than a third (32.9% in France, 30.4% in Germany, 27.9% in Belgium and 21.6% in Spain). Accordingly, the share of tax receipts accounted for by local taxes and social security funds is substantial in some Member States and very small, or even null, in others.

2.2.3. Major types of taxes: direct, indirect and social contributions

There are three main categories or types of taxes: indirect, direct taxes and social contributions.[11] As regards the **breakdown** of tax receipts by types of tax, the pattern at EU level is one of roughly equal thirds.

Figure 3: Tax revenue by major type of taxes, 2012 (% of the total tax burden)



Source: Taxation trends in the European Union (2014).

This split also conceals disparities between Member States, related to national tax structures.[12]

2.2.4. Breakdown by economic function

The breakdown by economic function (**consumption**, **labour**, and **capital**) shows that at EU level, **taxation of labour** accounts for the lion's share of tax receipts, followed by taxation of consumption and taxation of capital. There are significant differences between Member States.

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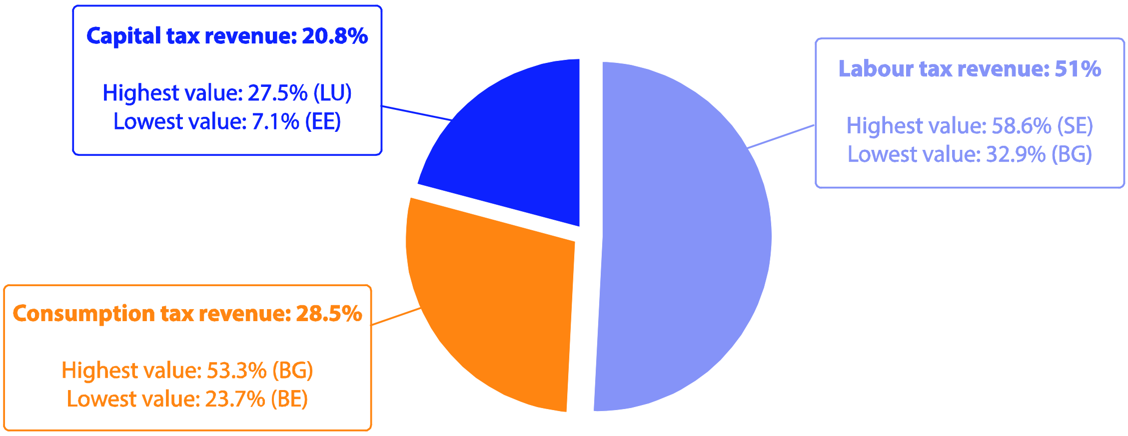
[11] Includes contributions payable to social security funds or other social insurance schemes as well as imputed social contributions, included in statistics in the definition of compulsory levies to allow greater comparability over time and across countries. See Taxation trends in the European Union 2014 p. 270: 'In practice, imputed social contributions relate to governments, which do not pay actual contributions for their employees but nevertheless guarantee them a pension upon retirement; imputed social contributions represent the contributions the government should pay to a pension fund in order to provide a pension of an equivalent amount to its employees.'

[12] Evolution of the relative share during the 2010-2014 period can be found for instance in Tax reforms in EU Member States - Tax policy challenges for economic growth and fiscal sustainability 2014 Report ('Tax reforms - 2014 Report'), p. 15: 'Evolution of tax revenues'.

Figure 4: Distribution of the total tax burden according to type of tax base, 2012 (% of total tax burden)



Source: Taxation trends in the European Union (2014).

2.3. Taxation and other policy objectives

2.3.1. Internal market

Harmonising indirect taxes and work undertaken on direct taxes are linked to the establishment of a well-functioning single market. Taxes could potentially create distortions undermining the single market, and result in discrimination or affect free movement (of persons, services and capital).

In the single market, national administrations monitor and control the flow of intra-EU trade and related tax, mainly thanks to the use of the VAT information exchange system (VIES) and the excise movement control system (EMCS); both systems contribute to the fight against fraud.

2.3.2. Competition policies

From a business perspective, it is rational to base businesses where conditions are more favourable, which can result in 'treaty-shopping' (tax planning). When a taxation regime confers economic advantages on a specific operator (which by definition affects and distorts competition), this can raise concerns linked to the prohibition of state aid enshrined in Articles 107 to 109 TFEU.[13] The Commission is granted the power to decide on the legality of state aid on the basis of treaty provisions, secondary legislation and EU case law. It can monitor, verify, and restrict, and have aid recovered by the Member States. As regards the form, all forms and levels are covered by the prohibition and measures amounting to state aid must be approved before they can be implemented, unless they are exempted under block-exemption measures.

Tax provisions can have the effect of conferring an economic advantage which can fall under the state aid prohibition and be assessed and treated accordingly. Several tax regimes have been assessed and investigated under competition provisions.

[13] See Commission Notice on the application of the State aid rules to measures relating to direct business taxation (Official Journal C 384 , 10/12/1998 p. 3)

Jean-Claude Juncker's Commission has indicated that competition policy instruments will continue to be used for the fight against tax evasion, contributing to the Commission's strategy for growth and employment.[14]

Examples of tax-related competition concerns

Tax rulings are tax practices whereby companies are sent indications and legal guarantees from tax offices of how they will be dealt with, i.e. anticipatory tax decisions. This can be problematic since it can lead to reduced tax liability, contrary to the principle of a level taxation playing field, and distort competition in the single market through selective tax advantages.[15] An enquiry by the European Commission under state aid rules[16] on tax rulings has recently been broadened and now covers all Member States.

Regimes applied for **offshore companies**,[17] for instance when a specific tax regime exempts companies without any trade or business from corporate tax, may also raise competition concerns.

Exemptions from certain taxes (namely CIP) to some public undertakings are also assessed under state aid provisions, in as much as they could confer on them an economic advantage compared to other, unaided undertakings. Among tax systems under assessment based on EU state aid provisions, the Commission has been investigating specific tax regimes.[18]

2.3.3. As a tool for particular policy objectives

Taxes can be introduced for specific purposes, e.g. environmental or health objectives, which also bring in tax revenues.

a) **Taxes related to the environment**

This refers to taxes with an environmental, rather than a fiscal motivation. They relate to four main categories: energy, transport, pollution and resources. Environment-related taxes also apply at different stages of the value chain (extraction, industrial stage or final stage).

For statistical purposes, environmental taxes are defined as 'A tax whose tax base is a physical unit (or a proxy of a physical unit) of something that has a proven, specific negative impact on the environment, and which is identified in ESA [European System of Accounts] as a tax'.[19] The tax base was seen as the only available criteria allowing international comparison.[20] Legal definitions of environmental taxes across countries can be different, since their definition has an influence on tax policy. It is also different from taxes allocated for environmental purposes.[21]

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14 Mission letter to European Commissioner for Competition, 10 September 2014.

15 Some of these multinational companies are also facing investigations elsewhere; see for instance US investigation regarding Apple taxation.

16 See Directorate-General for Competition page on state aids and 17 December 2014 press release.

17 See for instance Court case C-106/09P November 2011 on corporate tax. See also recent state aid decision (SA.34914).

18 As an example of a regime exempting some harbours, from CIP in the Netherlands.

19 See Regulation (EU) No 691/2011, also used by the OECD and the United Nations System of Environmental-Economic Accounting (SEEA 2012) (international standard adopted in 2012*).*

20 A list of tax bases was drawn in agreement between Eurostat, Commission Directorates-General Environment and Taxation, the OECD and the International Energy Agency in 1997 (updated in 2011-2012).

21 For a detailed presentation see Environmental taxes - A statistical guide, Eurostat, 2013.

From the point of view of economic theory, environmental taxes are levied on a market activity that generates negative externalities (costs) not transmitted through prices. Externalities are related to the environmental consequences of production and consumption. However, another element needs to be kept in mind: environmental taxes encompass significant exemptions, which can apply either to green-energy or to polluting industries (in other words, tax bases are narrowed by other policy objectives).

From a tax revenue perspective, the increasing place of environmental taxation in the economic debate in Europe, does not translate into corresponding application of environmental taxes. Environmental tax revenues have limited possibilities for growth and the energy tax share remains the largest. As for the proposal for a directive[22] restructuring the framework for the taxation of energy products and electricity, there is as yet no agreement in the Council.

b) **Health-related taxes**

'Fat taxes' refer to specific non-harmonised taxes introduced in several Member States on specific categories of food and ingredient, linked to obesity and related diseases (e.g. soft drinks, ice cream, confectionery, sugar, salt or fat). The health objective is to achieve a reduction in the consumption of the targeted foods or ingredients in order to improve nutrition. Substitution from one taxed food or ingredient to another untaxed equivalent has an impact on the intended health effect of the tax (since what is important is the individual nutrient intake). As a result, the health objective is better achieved when such taxes are not limited in scope but apply to product categories with similar nutritional profiles (in terms of salt, sugar or fat). This refers, in terms of tax policy, to broad tax bases which offer less scope for substitution.

From a health perspective, there is debate on the contribution of food taxes to public health improvements. A recent study indicates that for these relatively recent food taxes there is as yet no conclusive evidence on their impact on public health[23] since public health studies require long-term data to assess effects on diet, obesity and non-communicable diseases.[24]

c) **Taxes related to financial services**

Financial activities are taxed differently in the EU Member States and are generally exempted from VAT. Taxes on financial services are applied in some Member States, for instance a 'wage tax' (in Denmark), a systemic risk or stamp duty tax (in France). The 'Financial Activities Tax' (**FAT**) was initially proposed by the IMF in 2010 as a way to correct a distortion across economic activities related to the exemption of financial activities from VAT. There are several designs for such a tax.

The 'financial transaction tax' (**FTT**) is an attempt to harmonise the taxation of the financial sector at European level, through enhanced cooperation between 11 Member States (Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia). Recourse to enhanced cooperation follows the lack of unanimous support in the Council for the proposal[25] for a common FTT system based

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22 Proposal amending directive 2003/96/EC, 2011/0092(CNS)

23 This is explained by the fact that taxes are rather recent, that the substitution effect has to be taken into consideration, as well as the fact that the tax impact for individual persons can differ from the global impact.

24 Non-communicable diseases include diabetes and cardiovascular diseases.

25 2011/0261(CNS) 'Common system of financial transaction tax'.

on Article 113 TFEU.[26] The proposal currently under discussion[27] 'aims at taxing gross financial transactions at a low rate to discourage short-term transactions along the polluter-pays principle'. It includes taxation according to the 'residence principle' (of at least one of the parties to the transaction), complemented by the 'issuance principle' (transactions in instruments issued in one of the participating Member States).[28]

3. Present context of taxation

The structure of taxation systems was set up for 'bricks and mortar' organisations. Globalisation of the economic environment and structural changes resulting from information and communications technologies (ICTs) render classic taxation systems out-dated. To these changes, the financial and economic crisis added the need for countries to find resources in a constrained economy. Together they placed the need for structural reforms and for policy-makers to look at links between tax, growth and equity, beyond fiscal consolidation (reducing debts) on the agenda. Not all taxes or categories of taxes are equally affected, with differences between personal and business taxation, and also between indirect and direct taxation.

3.1. Tax competition and digitalisation

In addition to globalisation and increased tax competition, digitalisation resulting from the use of ICTs has changed the economy as a whole, and created new business models of global significance. Both have forced adaptation in many fields, including tax.

3.1.1. Tax competition

Tax competition has always existed. From an economic point of view, tax competition is often viewed as a substitute for market competition to induce efficient spending in the public sector. This lies on the assumption that taxpayers will change location if public spending does not match their expectations. However, a real difference exists between individuals (taxpayers of personal income tax – PIT) and firms (taxpayers of corporate income tax – CIT); the latter are more capable and readier to take advantage of tax competition, according to their size and activity.

As for **individuals**, in a multi-country setting other barriers (such as languages and social preferences) render tax competition ineffective, as most[29] individuals will not change their place of residence to leave states which can be seen as having 'inefficient' public sector spending. Individuals in the EU do not generally exercise their freedom of movement on the basis of public sector efficiency, or benefits,[30] or taxes.

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[26] The Council authorised enhanced cooperation through Council Decision 2013/52/EU following the European Parliament's consent given on 12 December 2012 2012/0298(APP). A legal challenge was not upheld by the Court of justice, in its judgment of 30 April 2014, in case C-209/13.

[27] 2013 /0045(CNS) 'Implementing enhanced cooperation in the area of financial transaction tax' based on Council Decision 2013/52/EU and article 113 TFEU.

[28] Cooperation from providers of clearing systems, with implementation requiring electronic systems which document worldwide transactions – in stocks and bonds – issued by the 11 Member States may prove necessary.

[29] See A. Bénassy-Quéré e.a. Tax harmonization in Europe: moving forward, referring to studies indicating that there is no evidence that mobile skilled labour, even with high revenues and high skills, generally tends to locate on the basis of tax reasons.

[30] This aspect is debated but the available research does indicate that EU-mobility does not operate this way, see for instance the recent 'The Fiscal Effects of Immigration to the UK' UCL study.

As for **firms**, national borders rendered competition between tax jurisdictions decisive in the choice of location for activities. When businesses reach a certain size, they have the opportunity to locate and to split their (physical and intangible) activities, so as to allocate them to several locations on the basis of the most advantageous set of relevant tax rules. In addition, such an allocation of activities can be organised independently of value-generating activity. With the globalisation and digitalisation of the economy, capital mobility has increased. This provides options for choosing business location in connection with taxation. In other words, it sets the conditions to engage in tax planning ('treaty shopping'). When operators are large enough to design a tax-oriented organisation they can minimise their tax obligations by shifting profits from high to low-tax jurisdictions, using intra-group transactions, the financial structure of a group, or the location of intangible assets. Tax competition can turn into a 'race to the bottom', and ultimately, aggressive tax planning. Here, countries also enter into tax competition, particularly on tax rates applied on tax bases which are mobile and can easily be moved (mostly capital).

Tax competition between countries (tax jurisdiction competition) consists of attempting to attract either economic activity or the corresponding tax revenues. Such competition is particularly vigorous in taxes which have mobile tax bases, a good example being **corporate tax**. Evolution of nominal tax rates is an indicator of this competition. Another form of tax competition is **specific tax treatment of foreign source income or intellectual property elements**. When a tax base is not actually mobile, the place where taxation occurs cannot be influenced by the business choice of location, which leaves little room for tax competition between countries, since their decisions would not result in attracting activity or corresponding tax revenues (for instance indirect taxation, VAT rates).

Tax competition, by its very nature, is **asymmetric.** This means that some benefit from tax competition at the expense of others. This applies to tax-payers (mostly businesses) and also to countries. Low-tax countries benefit from tax competition whereas high-tax countries are more likely to lose tax resources as well as economic activity (and ultimately growth). Within the EU, tax competition asymmetry can be seen reflected in positions towards tax harmonisation: low-taxation countries are more likely not to support pooling of tax authority than high-taxation countries, however this is a simplified picture.[31] Lastly, tax competition is not based on an approach of joint optimisation.[32]

Tax competition's **impact on growth** is generally recognised. Standard economic theory sees tax competition as detrimental to growth. Tax competition may also affect growth through its impact on **inequalities**. Economists have concluded that 'On the whole there is no evidence that higher taxes in general are detrimental to growth... Taxation may hurt growth only when it becomes confiscatory, in which case it stops innovation by the most productive entrepreneurs or induces them to move to a lower-tax country.'[33]

[31]. See Fabio Wasserfallen 'Political and economic integration in the EU: the case of failed tax harmonization'.

[32] See A. Bénassy-Quéré e.a. Tax harmonization in Europe: moving forward, p. 2.

[33] 'Tax harmonisation in Europe: moving forward', p. 7, in particular studies referred to in footnote 23.

3.1.2. Digitalisation

The digitalisation of the economy has led to the emergence of new economic models: digital economic models are based on intangible assets (intellectual property) and obviate the need for firms or individuals to be physically present in the country in which a service is provided, or even to have a fixed geographic location of any kind (cloud computing makes it possible to provide services from practically anywhere using mobile terminals). The digital economy is characterised by mobility (intangible assets which can be located anywhere), network effects[34] and use of data (big data). It includes different types of activities[35] which can be difficult to locate.

Digitalisation has also had an impact on economic models in general, facilitating cross-border activities, both in the EU's internal market and with the rest of the world. Non-ICT businesses operate using ICTs to a greater or lesser extent depending on their activities (e.g. there is a big difference between financial services and construction).

The distinction between the digital and the whole (mainstream) economy is blurred. This phenomenon poses a challenge to tax systems, in particular in company taxation. For instance, the permanent establishment criterion is more difficult to determine, although it is a fundamental element for taxation, and the user cannot have any control as to the location of the activity. Some have called for a specific tax regime for online companies (referred to as a 'Google tax'). Yet experts see the solution not in a specific tax system for online companies, but rather in the consistent application of general principles, as regards VAT and company taxation (corporate tax). In other words, as the May 2014 'Report of the Commission expert group on taxation of the digital economy' indicates:

> 'There should not be a special tax regime for digital companies. Rather the general rules should be applied or adapted so that digital companies are treated in the same way as others'.

The changes also offer an incentive to adapt. They have highlighted the need for simplification, transparency and stability, not only in order to prevent treaty shopping (tax planning), but also, and above all, in order to create conditions conducive to growth (for the e-economy and for the economy as a whole). Based on the fact that complexity creates loopholes as well as avoidance and evasion opportunities, streamlining tax systems would provide benefits. Key features are neutrality and simplicity, along with well-coordinated and administered tax systems.

As regards VAT, for a number of mobile transactions linked to **telecommunications services** (television, broadcasting services and electronically supplied services[36]), a recently updated system applies the **destination principle**, according to which tax should be paid to the Member State in which goods or services are consumed. This entered into force on 1 January 2015. Taxable persons supplying telecommunication services to non-taxable persons in Member States in which they do not have an

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[34] This refers to the fact that competition in price is limited but competition occurs in the quality and utility of the products with the 'winner-takes-it-all' models.

[35] Covers physical distance-selling, digital e-commerce and cloud models and multi-dimensional models such as search engines, social networks and other free digital service websites combined with advertising.

[36] The scope of the 2015 VAT MOSS is more limited than for e-commerce. These changes are relevant only insofar as the customer is a final consumer.

establishment will be able to account for the VAT due on those supplies through a web-portal in the Member State in which they are identified.

Mini one-stop shop

The 'Mini one-stop shop' (MOSS) is a simplification measure designed for telecommunications services. For the services covered, the VAT 'place of supply' is in the Member State of the customer. It is optional, but companies which decide to apply the scheme must do so in all Member States. It will apply to EU and non-EU suppliers for the transactions covered.

The scheme allows suppliers to avoid registering in each Member State of consumption (as was the case for supplies of electronic services to non-taxable persons by non-EU suppliers before 2015). In order to ensure the correct taxation of these services, providers will need to determine the status of their customer (a taxable or a non-taxable person) and the place (within or outside the EU) to which that customer belongs.

3.2. Taxation, consolidation and growth

Tax policy design 'can help address consolidation needs, stimulate efficiency, competitiveness and job potential of the EU economy, while promoting social inclusiveness.'[37]

In the context of the European Semester, focus is placed on building growth, as is also the case with measures relating to taxation. Taxation reforms are on the agenda of most Member States.[38] They were included in country-specific recommendations for 2013-14 for 24 of the Member States, and are assessed in the framework of the European Semester.

3.2.1. Taxation design objectives

There are two sides to public expenditure control: limiting expenditure and increasing and re-organising revenue. From the revenue side, taxation can play a role in consolidating public finances and fostering their **sustainability**. In the current economic situation, stimulating growth and job creation has become the over-riding objective, since **growth** brings more revenue, helping fiscal consolidation (and vice versa).

A **fairness** objective adds to sustainability and growth. The three objectives, which are sometimes contradictory, need to be balanced between themselves. Tax systems which are 'carefully designed can help redefine the triangle between them'.[39]

Reforms undertaken for fiscal consolidation have increased the overall tax burden across the EU (comprising direct and indirect taxes and social contributions). Reforms mean, in general, a shift from the taxes most detrimental to growth, such as labour tax and corporate income tax, to revenue sources less harmful to growth.

When focus is rather on short-term effect[40] as in the case of a monetary devaluation, the tax shift is referred to as a fiscal devaluation. When accent is placed on expected long-term gain objectives, in terms of growth and jobs, this is referred to as tax shifting.

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[37] Tax reforms in EU Member States -Tax policy challenges for economic growth and sustainability 2013 Report ('Tax reforms - 2013 Report'), p. 9.

[38] A summary of tax changes adopted from mid-2013 to mid-2014 can be found in Tax reforms - 2014 Report, p. 18

[39] Tax reforms - 2014 Report, p. 11.

[40] Tax reforms - 2013 Report, p. 11. '"Tax shifting" here refers to shifting taxation from the most growth-detrimental taxes, such as labour tax and corporate income tax, to revenue sources less harmful to growth. The objective is generally long-term gain, in terms of growth and jobs. "Fiscal

Another concept is the tax space, which consists of a reasonable margin to increase taxes. Not all Member States enjoy a tax space. When this is not the case, tax design and tax governance are relied upon to raise economic efficiency, and consequently increase revenue, but it may still be necessary to raise taxes further.[41]

3.2.2. Growth-oriented changes in tax structure

Tax reforms in the EU Member States are reviewed in an annual report drawn up by European Commission Directorates-General for Economic and Financial Affairs (ECFIN) and Taxation and Customs Union (TAXUD). The 2014 report looks over the most important recent tax reforms in the EU Member States. The main general trends show an increase in the overall tax burden, with an increase in indirect taxes but the tax burden of labour taxation is decreasing in a majority of countries (although increasing in some), and toughened measures on the fight against tax fraud and evasion.[42]

Of course, shifting the tax burden from labour requires compensation for cuts in other areas. Designing labour tax shift is important, in particular choosing between a reduction of labour income taxation across the board and a reduction targeted at specific groups. The groups specifically targeted are mainly low skilled/low earning, secondary earning, young and unemployment trap[43] groups. Overall labour elasticity is very low, but there are segments of the labour market that are sensitive to financial incentives or face particular financial discouragements. Targeted interventions require that the administrative costs of task collection and the risks of opportunistic behaviour be controlled.[44]

It is also important to compensate for such a shift in a way which supports consolidation and growth-friendly reorientation. Taxes which are less detrimental to growth such as consumption (VAT, excises), recurrent taxes on immovable property, and environmental and health-related taxes are used to compensate for the resulting tax revenue loss. Consumption taxes represent the largest share. Immovable property and environmental taxes are of more limited use for several reasons, including the fact that they also have non-tax objectives. As for immovable property taxes, they are sensitive due to their possible intergenerational (inheritance) and business transmission impact. They also include some difficulties or limitations linked with cadastral values which need to be updated, to ensure that this tax base keeps its value and is not eroded by inflation, in the medium and long term.

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devaluation" —currently topical because of the sovereign debt crisis affecting peripheral euro area countries— is a specific type of tax shift. It often takes the form of a decrease in labour taxation, notably employers' social contributions, financed by an increase in VAT. The objective of fiscal devaluation is to improve impaired competitiveness vis-à-vis trade partners in the short term and thereby to accelerate the necessary correction of the current account deficit. Fiscal devaluation, which mimics the effects of currency devaluation on the terms of trade, would be most efficient for countries with large external imbalances.'

41 See Tax reforms - 2014 Report, p. 49.

42 Presentation of 'Recent reforms of tax systems in the EU' in Tax reforms - 2014 Report, p. 17-43

43 Tax reforms - 2014 Report, p. 129: unemployment trap 'measures the part of the additional gross wage that is taxed away in the form of increased taxes and withdrawn benefits such as unemployment benefits, social assistance, housing benefits when a person returns to work from unemployment. The "trap" indicates that the change in disposable income is small and, conversely, the work-disincentive effect of tax and benefit systems is large.'

44 'Assessing the impact of a revenue-neutral tax shift away from labour income in Spain', ECFIN *Country Focus*, p. 3.

As regards general tax design, efficiency gains can be obtained by broader tax bases (with fewer exemptions and preferential rates) and lower rates, compared to systems characterised by narrow bases and higher rates. This can result in a less distortive system since fewer exemptions and preferential rates reduce space for planning strategies to benefit from the latter.

Design and governance elements can also contribute to supporting the tax shift:

- Strengthening tax efficiency by improving tax compliance,
- Limiting tax relief (e.g. provisions allowing deduction from tax bases, for instance for mortgage interest payments, in personal taxation, or deduction of interest payments from corporate tax, referred to as debt bias),
- Updating tax bases and keeping them updated to match reality (for instance updating cadastral values of immovable property to keep them in line with current values).

3.2.3. In perspective

The effect of a tax shift on firms (and beyond that, on economic activity) not only results from changes in labour taxes and CIT. In particular, the taxes increased in a tax reorientation, such as environmental taxes, VAT property taxes and local or regional taxes, in turn affect turnover and production. A 2014 study computes tax incidence and tax reforms on effective corporate taxation.[45] It complements existing empirical studies on the effect of corporate tax rates on the economic behaviour of companies (location, investment choices and profit-shifting strategies) and tax competition between jurisdictions. It underlines that:

> 'Research in support of tax policy formulation should consider other production factors as well, especially when devising strategies aimed at shifting the tax burden in order to favour growth and employment creation. In particular, our cross-country/cross-sector approach allows us to gauge the effects of tax changes on the incentives provided by the tax system to increase economic activity.'[46]

Finally, regarding public finance consolidation in the euro area, integration has fostered 'a pooling of tax authority at European level which is different from harmonisation which is linked to the single market.'

4. Challenges for EU taxation policy

A number of priorities have emerged in the context of the effort to strengthen EU tax policy and fairness. Improved cooperation and coordination within the EU, and at international level, are directed at fighting tax fraud and tax evasion, as well as combatting aggressive tax planning, in particular through more effective tax cooperation and exchanges of tax information among countries.

[45] Taxation paper No 45 Effective Corporate Taxation, Tax Incidence and Tax Reforms: Evidence from OECD Countries'.

[46] In the conclusion of the study, p. 26.

4.1. Fair taxation and recuperation of lost resources

Tax evasion and tax fraud are not fought simply to recover unpaid revenue from taxation, but also to restore fiscal fairness, benefiting both public budgets and taxpayers.

4.1.1. Framing taxation: fair taxation

Taxation can be seen from the public authority side (revenue) or from the side of the taxpayer (expenses). Links between taxing and spending contribute to increasing the perception of fairness and compliance. However, it may not be clear to taxpayers (including individuals and undertakings ranging from small or very small entities to multinationals) that they are buying public services when paying taxes, since the link between taxation and the provision of public goods may not be evident. Economic theory has long considered the taxpayer as a rational individual seeking profit maximisation and adopting decisions accordingly. However, not all taxpayers are faced with tax maximisation issues based on rational assessment processes before taking decisions. In particular, individual taxpayers buying goods, services or property in the course of their life do not generally consider, or have the option of, moving to another country for tax purposes. In addition, some taxes are closely linked with territorial location (site of a property or place of consumption, for instance).

Tax compliance refers to willingness to comply with tax laws, declare the correct income, claim the correct deductions, relief and rebates and pay all tax on time. At the taxpayer level, compliance is supported by the fight against tax evasion and fraud, without which non-abiding taxpayers would gain an economic advantage likely to deter compliance. This can be rendered more effective by making tax systems simpler, less burdensome to comply with and more predictable, so that it is easier and cheaper for individuals to meet their tax obligations.

Behavioural economics and taxation

Classical economic models consider taxpayers to be decision-makers, seeking an economically optimal situation. Behavioural economics in taxation draws a more complex and nuanced portrait of taxpayers, where moral suasion in tax collection, culture, and the likelihood of being audited play an important role.

However, studies **mostly** consider personal income tax and **individuals**. They underline several elements: the fact that tax compliance is affected by the quality of publicly provided goods and services, the fact that individuals cooperate in cases where they expect others to cooperate – compliance – and tend to limit cooperation when others do not, the influence of the cultural environment and social norms of behaviour, as well as the perceived probability of being audited.[47]

The fairness objective (and the related objective of a level playing field) contributes to compliance, and results in limiting avoidance, evasion and fraud, all of which deprive Member States of tax resources.

4.1.2. Lost resources

Examples of action taken by Member States illustrate the results of decisions aimed at making the system fairer and more efficient by curbing tax fraud and tax evasion.[48]

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[47] Taxation papers n°41 Behavioural economics and Taxation, Weber T.O., Fooken J., Herrmann B ('Behavioural economics and Taxation').

[48] Examples of resources obtained by measures adopted by Member States can be found in Tax reforms- 2014 Report p 25.

Tax receipts lost to public finances in the EU

The **compliance gap** describes the difference between tax collected and the theoretical tax due, whereas the **tax gap** is used to 'describe broad phenomena' covering a range of tax issues, including for example, undeclared work, VAT fraud, aggressive tax planning (CIT) and tax avoidance (PIT).

The total volume of revenue lost to national budgets and the EU budget as a result of **tax fraud and evasion** is put at €1 000 billion per year. The value of the EU shadow economy reportedly amounts to roughly 20% of official GDP.

The **VAT gap** (unpaid VAT) in the EU was assessed at €177 billion in 2012, which represented 16% of the total volume of VAT payable; some of this loss is accounted for by tax fraud and evasion[49] but also by errors, legal tax planning, etc. Another element is the estimate that VAT revenue could increase by 43% through introducing a single rate across the EU (set at the prevailing standard rate), i.e. by ending exemptions and reduced rates.[50]

The European Parliament has called[51] on the Commission to launch a study into possible indicators constituting the basis for reduction of tax fraud, evasion and avoidance and to set tangible targets for reduction of the tax gap at European and national levels. Creation of standardised indicators would allow assessment of the size of the underground economy and tax gap. However, the first step is to harmonise appropriate estimates made by national statistical offices. This is a pre-requirement for setting and using a measurable and binding set of targets (in connection with Europe 2020, the European Semester, National Reform Programmes, and Stability or Convergence Programmes).

4.2. Combating tax fraud and evasion

4.2.1. Tax fraud and tax evasion

Fighting tax evasion and tax fraud is a priority, as both the European Parliament and the Council have repeatedly stated. They confer a competitive advantage on those who escape their obligations as taxpayers and also sap taxpayer confidence, undermining the internal market and the confidence of EU citizens (in addition to the lost tax resources). The fight against tax fraud and tax evasion is high on the EU agenda, and the Commission has placed it among its priorities.[52]

Tax fraud and tax evasion concepts

Different concepts are used to describe the act of escaping or minimising tax compliance, namely:

(Tax) **evasion** (illegal): where income consumption or production are not (or are under-) declared for taxation despite the fact that they are taxable (linked to the shadow economy). Also includes pure tax evasion, not linked to any activity, with the sole purpose to conceal income or over reporting of deductible expenses (e.g. hiding money in tax shelters).

(Tax) **fraud** (illegal): where the intention is to deliberately escape taxation.

[49] VAT study gap issued 23 October 2014. A change of methodology explains the difference with the 2011 estimate.

[50] An example of a tax gap calculation regarding the UK can be found in Taxation papers No 41, p. 5. See also VAT gap study, p. 20.

[51] Namely in the resolution of 12 December 2013 on the call for a measurable and binding commitment against tax evasion and tax avoidance in the EU (2013/2963(RSP))

[52] See letter of 12 November 2014 from Commission President Juncker and Vice-President Timmermans to the Council and EP Presidents.

(Tax) **havens** and **offshore financial centres** describe jurisdictions that meet certain tax features, namely: no or minimal taxation on income and assets of non-residents, tax advantages to non-resident individuals, lack of effective exchange of relevant information with other governments on their taxpayers, minimal or no disclosure on financial dealings and ownership of assets, and generally not applying accepted minimum standards of corporate governance and accountability.[53]

Shadow (underground) economy: legitimate productive activities in which a payment is taxable but the seller neglects to pay taxes (often in common understanding with the buyer). **Undeclared work** (part of the 'moonlight' or 'black' sector or informal economy) constitutes the main share of the shadow economy. It is measured by the value on the black market of the production not reported to the tax authorities (not the amount of tax evaded). However, by their very nature, estimates of unobserved situations and hidden transactions face difficulties and limitations in their reliability. Assessment methods can be based on estimates of consumption[54] (between observable factors strongly correlated with true, but unobservable income), surveys (with the risk that people do not report their illegal behaviour), randomised tax audits and even lab experiments.

The fight against tax fraud and evasion covers both direct (in particular measures to combat damaging tax practices) and indirect (unpaid VAT) taxes. It relies in particular on information sharing.

4.2.2. At EU level

The Commission presented an **EU action plan** in December 2012.[55] The plan comprises 34 actions to be carried out in the short and medium term. It covers, in particular, good tax governance and tax transparency (at national, European and international level), combating harmful practices, VAT and business taxation. The actions relate to increasing the exchange of information within the EU, fighting VAT fraud more effectively, disincentives to commit fraud and the coordination of international tax agreements at EU level.

The multiannual **Fiscalis** programme (launched in 1993) currently covers the 2014-20 period. The objective is to enhance cooperation between Member States to improve the proper functioning of taxation systems in the internal market. Specifically, the programme supports the fight against tax fraud and tax evasion, as well as aggressive tax planning.

The European Parliament adopted a resolution on 12 December 2013 on the call for a measurable and binding commitment against tax evasion and tax avoidance in the EU, based on the Commission action plan to tackle tax fraud: 'The EP welcomed the efforts of the Commission to intensify the fight against tax fraud, tax evasion and aggressive tax planning with a view to reducing the tax gap'.

Exchange of information (upon request, without request and computerised automatic exchange) provides tax authorities with elements which help to identify and track evasion and fraud. It requires proper and usable identification of taxpayers. The EU '**Tax**

[53] Policy Department study 'European initiatives on eliminating tax havens and offshore financial transactions and the impact of these constructions on the Union's own resources and budget' p. 31.

[54] Some examples include: using British food survey (1989) and consumer loan data from major banks to assess real household income (Greece 2012), see Behavioural economics and Taxation, part 2 'Measuring tax evasion', p. 8.

[55] Together with a recommendation on aggressive tax planning and a recommendation on good tax governance with third countries.

identification number' (TIN) contributes to efficient and automatic identification of taxpayers for direct taxes.[56] The objective is to 'overcome the current difficulties faced by Member States in properly identifying all their taxpayers (natural and non-natural persons) engaged in cross border operations.'

Transparency and banks

In the EU, country-by-country reporting (**CBCR**)[57] for banks, included in the Capital Requirements Directive (**CDR4**) adopted in 2013, will have the ancillary effect of reducing manipulation of earnings in order to pay less tax. CBCR places an obligation upon EU **banks** to disclose information about their activities anywhere in the world, allowing a better picture of the true economic situation of a bank.

The main objective is the following: 'Increased transparency regarding the activities of institutions (financial), and in particular regarding profits made, taxes paid and subsidies received, is essential for regaining the trust of citizens of the Union in the financial sector. Mandatory reporting in that area can therefore be seen as an important element of the corporate responsibility of institutions towards stakeholders and society' (Directive recital 52). Transparency will expose profit-shifting between countries to escape tax.

An additional step in **transparency** was decided in the wake of tax rulings issued by Member States' tax administrations to large multinational companies, allowing them to drastically reduce the taxes to be paid (in other words, avoiding taxes as a result of worldwide tax planning). The Commission has announced that it will put forward a proposal to ensure transparency of tax rulings, bringing them into the scope of automatic exchange of information.

4.2.3. At international level

Cooperation takes place in bilateral or multilateral settings.

Efficiency implies that **sharing of information** is not limited by national provisions (allowing limited transparency or secrecy), which offer a shelter to funds resulting from tax evasion or fraud. In this perspective, strong emphasis has been placed on reducing bank secrecy and improving information sharing. At international level, information sharing has progressed. This is the case regarding the international facet of savings, with the Directive on Taxation of Savings Income in the form of interest payments adopted in June 2003. The Directive includes transitional periods linked to agreements with **five European countries**, i.e. Switzerland, Liechtenstein, San Marino, Monaco and Andorra to exchange information upon request as defined in the OECD model agreement. Agreements were signed between the EU and each of these countries in 2004 and applied since July 2005. Changes are currently being negotiated.

At multilateral level, the 29 October 2014 agreement on the early application of the new OECD global standard (GS) on the 'Automatic exchange of information' (**AEOI**) was signed by 50 countries (including the 28 EU Member States). It foresees that signatories will start, in 2017 instead of 2018, to exchange the information they are to collect from 31 December 2015. The agreement is a very important step, but a first step only (e.g.

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[56] This is one of the measures of the 2012 action plan on the fight against tax fraud and tax evasion.

[57] Article 89 reads as follows: 'From 1 January 2015 Member States shall require each institution to disclose annually, specifying, by Member State and by third country in which it has an establishment, the following information on a consolidated basis for the financial year: (a) name(s), nature of activities, (b) turnover; (c) number of employees on a full time equivalent basis; (d) profit or loss before tax; (e) tax on profit or loss; (f) public subsidies received. and geographical location;'

The Report from the Commission was adopted on 30 October 2014. There is a dedicated website

countries have the ability to decide on a case-by-case basis with which countries they exchange data). As regards the coverage of the agreement, important third-country financial partners are not yet signatories, though some countries have indicated their intention to apply the AEOI standard in the near future. The 2010 US 'Foreign Account Taxpayer Compliance Act' (FATCA)[58] provides similar elements to those included in the OECD standard. EU Member States[59] will apply the AEOI in 2017 under the revised directive on administrative cooperation, which aims to transpose the global OECD standard on the AEOI into EU legislation, as agreed at Council level on 14 October 2014. The EU Savings Tax Directive includes a more limited provision and will be suspended once AEOI applies.

Cooperation with EU trade partners (e.g. in the context of the Asia-Europe meeting) includes the need for further progress in the fight against tax evasion and tax avoidance, in conjunction with improvement of transparency (through the OECD standard).

4.3. Reducing tax avoidance

Tax avoidance is in principle legal but not provided for by legislation (permitted re-arrangement of income: e.g. remuneration in the form of dividends, lower taxed income, conversion of expenses into tax-deductible expenses).

4.3.1. Cooperation

There is a need to work together and commit to 'certain rules of the game' to prevent tax competition being used to aggressively minimise tax obligations and reduce countries' tax revenues. Uncoordinated competition can amount to a race in tax shrinking. Unilateral actions to address tax competition are of limited efficiency since a tax base can simply move to a location where no such actions are undertaken. In other words, there is a need for cooperation, working together to achieve joint optimisation.

In a globalised economy, where the use of ICTs can turn transactions into murky or even opaque affairs, national tax systems cannot have knowledge of every single cross-border transaction. This lack of cooperation results in the most favourable tax system being applied at the expense of other national tax systems. Cooperation cannot be limited to within the EU's borders. Even though cooperation within the EU is more significant, bilateral or multilateral actions are also necessary.

In the EU, **administrative cooperation** between Member States aims to support the implementation of Union law in the field of taxation. There are several legal instruments, covering VAT and excise duties.[60] Cooperation includes practical tools and instruments, such as electronic formats for exchange of information, and secure communication tools and sharing of good administrative practices.

Tax recovery assistance in the EU has a broad scope since it covers all taxes[61] and duties of any kind levied by or on behalf of a Member State or administrative subdivision, including local authorities, or on behalf of the Union. Some researchers see it as an

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[58] Imposing on foreign banks the obligation to inform the US tax administration about American client accounts and deposits.

[59] Austria will apply the standard later, for technical reasons, by 2018.

[60] Council Regulation (EU) 904/2010, Council Directive 2011/16/EU and Council Regulation (EU) 389/2012

[61] Directive 2010/24/EU. However, compulsory social security payable to the State are excluded: Art. 2(3)(a) covered social security provisions R987/2009 and IR 883/2004.

'advanced concept of mutuality in recovery assistance' which includes, for instance, the existing possibility for tax recovery officials to exercise their powers in another Member State by agreement between tax authorities of the Member State concerned, and provides a uniform instrument permitting enforcement in the requested Member State.[62]

Bilateral agreements on administrative cooperation with certain third countries supplement this, to achieve sufficient cross-border anti-fraud cooperation.

The **Code of Conduct for business taxation** complements administrative cooperation instruments with peer review of tax measures. It defines harmful tax measures as 'measures (including administrative practices) which affect or may affect in a significant way the location of business activity in the Community, and which provide for a significantly lower level of taxation than those that generally apply in the Member State concerned'. Business taxation measures have been assessed under the Code.

Examples of tax avoidance practices

The use of 'patent boxes' is a preferential tax treatment (generally a reduced rate of tax on revenue) aimed at attracting businesses which develop, manufacture and exploit patents. When linked with the development of real activity they can support growth and innovation. They exist in several EU countries, as well as in third countries.

Such regimes are under assessment at EU level (in the framework of the code of conduct) and international level (BEPS – base erosion and profit shifting – an OECD project in the 'Forum on harmful tax practices'), but no interpretation has been agreed on the criteria for assessing whether those regimes constitute harmful practices. At EU level, 'patent box' schemes in force are under review.

Another example of tax avoidance consists of shifting profit between subsidiary companies, for instance, systems allowing companies who do not have tax residence in a country to set up an operation in that country for the sole purpose of transferring their profits to tax havens, a scheme known as the 'Double Irish'; national authorities have recently decided to end this possibility.

4.3.2. Closing tax loopholes

Tightening EU corporate tax rules against aggressive tax planning, preventing harmful tax competition and improving VAT tax compliance (based on study of the VAT gap) can contribute to closing tax loopholes.

In **indirect** taxation, in particular VAT, current transitional arrangements have several drawbacks among them the dual regime for intra-EU trade allowing sale without VAT, which bears the risk of fraud. This situation provides the conditions for carousel fraud, which is based on sale without VAT.

Dealing with a number of **company taxation** loopholes is on the agenda. The **corporate debt bias** is one element which may foster international tax avoidance. The distinction between debt and equity which exists in most tax systems may create opportunities for profit shifting, by increasing debt where profits are highly taxed, and equity where they enjoy lower rates. This is linked to the fact that systems generally allow for deductibility of debt interest payments, while the return on equity is not considered as a deductible

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[62] Possibility introduced by Directive 2010/24/EU concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures (article 7) and most recent legislation on administrative cooperation, for more elements see for instance: I. de Troyer (2014) 'Tax recovery assistance in the EU: analysis of Directive 2010/24/EU', EC Tax Review, 2014/3.

cost; this asymmetry favours debt over equity. Restoring symmetric tax treatment for debt and equity at corporate level aims at safeguarding the tax base at domestic and international level, which requires cooperation (in defining provisions and anti-avoidance measures).

Transfer pricing transactions[63] can raise difficulties, in particular regarding risk management in dealing with transfer pricing and adjustments. Those can result in double taxation or non-taxation because the interpretation and application of the 'arm's length' principle varies from company to company and tax office to tax office. The original **parent-subsidiary** directive aimed to avoid double taxation of profits made by cross-border groups, but when profit distribution is treated as a tax-deductible payment from a hybrid loan[64] in the subsidiary Member State, this leads to double non-taxation.

The above loopholes are being considered as part of the EU legislative process. Relating to tax treatment of **intra-group payments**, revision of the parent-subsidiary directive has progressed in two steps. The provisions on hybrid loans were adopted in mid-2014 in the revision.[65] Provisions allowing Member States to ignore artificial arrangements made for the purposes of tax avoidance and to apply taxation on the basis of genuine economic data (anti-abuse clause) are close to agreement.

On the treatment of **transfer pricing transactions**, Commission guidelines were published on 4 July 2014 and are drawn from the work of the EU Joint Transfer Pricing Forum (JTPF), which was established by the Commission to improve the smooth functioning of the single market and ensure better corporate tax coordination.

The proposal for a directive to establish a common consolidated corporate tax base (CCCTB)[66] was presented in 2011. The CCCTB, as presented in the proposal,[67] is a 'system of common rules for computing the tax base of companies which are tax resident in the EU and of EU-located branches of third-country companies. Specifically, the common fiscal framework provides for rules to compute each company's (or branch) individual tax results, the consolidation of those results, when there are other group members, and the apportionment of the consolidated tax base to each eligible Member State.' A comprehensive solution could eliminate a number of tax planning opportunities and at the same time eliminate most of the tax obstacles which affect the economic efficiency of the single market. The proposal has been on the negotiating table for three years without making progress. However, it is expected to be re-launched following concerns created by the use of tax rulings benefitting multinational companies.

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63 These are the costs of transactions between two arms of a multinational company in different countries (the price charged for inter-company transactions).

64 Hybrid loan arrangements are financial instruments that have characteristics of both debt and equity.

65 Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States

66 2011/0058(CNS) Currently CCCBT is designed as an option for companies. This means that 'Under the CCCTB, groups of companies would have to apply a single set of tax rules across the Union and deal with only one tax administration (one-stop-shop). A company that opts for the CCCTB ceases to be subject to the national corporate tax arrangements in respect of all matters regulated by the common rules. A company which does not qualify or does not opt for the system provided for by the CCCTB Directive remains subject to the national corporate tax rules': explanatory memorandum of the Commission proposal COM(2011) 121 final, p. 5.

67 Explanatory memorandum, p. 5.

At international level, cooperation takes place at bilateral and multilateral levels. Examples of bilateral cooperation with third countries have recently increased. Cooperation with EFTA states (Iceland, Liechtenstein, Norway and Switzerland) also offers a framework for bilateral cooperation. In this context for instance, the work of the code of conduct group helps identify company tax regimes held to be damaging by the EU. On this basis, a deal was reached with Switzerland (in October 2014) on ending five company tax schemes on the basis of the work of the code of conduct group. The reform objective is to end the distinction between taxing national and outside activities, ending a regime favourable to foreign companies.

At the OECD, the **BEPS** project tackles loopholes in national tax systems exploited by multinational enterprises to avoid paying taxes, or at least to reduce their taxable revenues. The BEPS project serves as a basis for G20 coordination and covers 44 countries, including all EU Member States. The project addresses preferential schemes such as 'patent boxes'.

Finally, the G20, at its recent Brisbane meeting, recalled the importance of fair taxation and improving tax systems to close loopholes and made the following declaration on taxation:

> 'Profits should be taxed where economic activities deriving the profits are performed and where value is created. We welcome the significant progress on the G20/OECD Base Erosion and Profit Shifting (BEPS) Action Plan to modernise international tax rules. We are committed to finalising this work in 2015, including transparency of taxpayer-specific rulings found to constitute harmful tax practices. We welcome progress being made on taxation of patent boxes. To prevent cross-border tax evasion, we endorse the global Common Reporting Standard for the automatic exchange of tax information (AEOI) on a reciprocal basis. We will begin to exchange information automatically with each other and with other countries by 2017 or end-2018, subject to completing necessary legislative procedures. We welcome financial centres' commitments to do the same and call on all to join us. We welcome deeper engagement of developing countries in the BEPS project to address their concerns. We will work with them to build their tax administration capacity and implement AEOI. We welcome further collaboration by our tax authorities on cross-border compliance activities.'

5. Outlook

EU fiscal policy began as a necessary ancillary measure to ensure proper functioning of the single market. As such, cooperation and harmonisation were limited to this end and Treaty provisions were established to provide tools to meet this objective. Further development of the EU and changes in the economy, now a globalised fast-moving environment, confer a much broader function on EU tax policy, since new business models, the increased operations of multinational firms and ICTs mean that national tax policies cannot be left to face these challenges alone, in isolation from the EU (and the rest of the world).

The traditional approach has relied on the assumption that there is no need for an across-the-board harmonisation of Member States' tax systems. However, the focus has broadened from the elimination of tax obstacles to the fight against harmful tax competition, fraud and evasion. These require greater convergence in fiscal policy,

which is expected to provide answers to the challenges and impetus to closing loopholes and establishing a level playing field.

The question remains of how the investment package proposed by the new Commission will be financed. Some commentators consider that 'the only solution is a fiscal Union', whilst acknowledging that, for the time being, this seems unrealistic.

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EU tax policy is based on national tax systems which are decided by Member States and adapted to prevent national tax provisions hindering the single market and cross-border activities.

Tax systems are under pressure to adapt and update as a result of budget consolidation and stimulating growth requirements. The challenges for EU tax policy include globalisation, digitalisation and tax competition, which offer greater room for avoidance, evasion and fraud – to which national and EU borders do not constitute an effective defence.

Tax avoidance and fraud call for convergence, either through cooperation or coordination, to fight against behaviour detrimental to fair tax systems and which penalises growth. Convergence is being developed at EU and international level, where exchanges, sharing and tackling tax loopholes are expected to be strengthened to provide an effective answer.

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