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Background note

Session 3: Combating Tax Evasion

Tax sovereignty is one of the fundamental sovereign rights of the Member States of the European Union (EU), which therefore has only limited competences in this field. Tax rules are developed in particular with a view to ensuring the smooth functioning of the single market. In parallel, the EU has stepped up efforts in recent years to fight tax fraud and tax avoidance, which generally affects indirect as well as direct taxes. The focus of this background note is on corporate tax fraud and tax avoidance, and on EU initiatives designed to prevent these practices.

Each year, **corporate tax avoidance** leads to lost revenues for public-sector budgets to the order of several billions[1]. With tax avoidance being a cross-border phenomenon, the problem often cannot be tackled by national measures alone. The OECD package to combat BEPS (*Base Erosion and Profit Shifting*) has set global standards for corporate taxation and proposed a series of measures to help countries combat corporate tax avoidance. On 5 October 2015, the OECD presented its final reports; in November 2015, the Action Plan was then adopted by the G20 heads of state and government. Initiatives to combat tax avoidance have been stepped up in recent years also at EU level, most of which are modelled on the BEPS measures. These concern in particular the areas of transparency and information exchange, ensuring taxation where value is created, and containing the double taxation risk.

Points for discussion:

- Have the measures taken so far been helpful in containing tax avoidance? If so, can progress which has been achieved be measured (e.g. in terms of higher tax revenues)?
- How much leeway do the individual directives leave for transposition into national law?
- How homogenous was their implementation in national legislation?
- What would be the extra benefits of a Common Consolidated Corporate Tax Base (CCCTB) as compared to the current regime?
- What are currently the key obstacles to the implementation of a CCCTB?
- Does BREXIT impact efforts at EU level to curb corporate tax avoidance?
- How are the European Commission's proposals to prevent VAT fraud in cross-border trading seen and by when could they be implemented?
- Where would it make sense to set up a reverse-charge system?

Key measures adopted at EU level in recent years in the area of **transparency and information sharing** include the following:

- Automatic exchange of information on financial accounts: the standard for the automatic

[1] According to the European Parliamentary Research Service, the shortfall within the EU caused by corporate tax avoidance amounts to EUR 50–70 billion annually.

exchange of information on financial accounts (CRS, Common Reporting Standard) was developed by the OECD and implemented by way of Council Directive 2014/107/EU amending Directive 2011/16/EU. The automatic exchange of information ensures an exchange of tax-relevant information between states with a view to fighting tax evasion.

- Automatic exchange of information on tax rulings: The existing administrative cooperation directive was amended by way of Council Directive 2015/2376/EU to ensure an efficient exchange of information between tax authorities with cross-border tax rulings and advance pricing arrangements. In some cases, tax rulings have led to artificially high revenues being subject to lower taxation in the country issuing the tax ruling and other countries involved being left with artificially reduced taxable revenues.
- Automatic exchange of information by means of country-by-country reporting. Council Directive 2016/881/EU extended the mandatory exchange of information to include an automatic exchange of information on country-by-country reporting. This concerns reports by MNE Groups posting annual consolidated revenues of at least EUR 750 million which contain information on the global distribution of revenues, taxes and the business activities of an MNE Group by countries or jurisdictions. This information shall enable the tax authorities to counter harmful tax practices.
- Transparency rules for intermediaries: On 25 May 2018, the Council of the European Ministers of Finance implemented the Commission proposal of June 2017 on new transparency rules for intermediaries by adopting Council Directive 2018/822/EU. Intermediaries are, inter alia, consulting firms, banks, tax consultants or lawyers who could help clients reduce their tax burden. The Directive requires intermediaries to report to the tax authorities cross-border models serving the purpose of tax avoidance or tax evasion.
- EU list of tax havens: In December 2017, the Council approved and published an EU list of non-cooperating jurisdictions and territories for tax purposes which is being updated regularly (at least once a year). The updated list currently still features seven countries, as against 17 countries in December. The number of countries on the grey list however increased from 47 to 65.

A package of measures to combat tax avoidance was adopted at EU level in 2016, including some of the above measures on transparency. A central element of that package is Council Directive 2016/1164/EU against tax avoidance (***Anti-Tax Avoidance Directive*, ATAD**), which was adopted by the Council on 12 July 2016 and is to ensure **taxation where value is created.** This Directive implements certain recommendations from the BEPS initiative, thereby requiring EU Member States to take legally binding measures against aggressive tax planning.

The Directive is to apply to all taxable persons – including permanent establishments of companies from third countries - if they are subject to corporate tax in one or more Member States. Specifically, the Directive is to avoid that corporations take advantage of mismatches between the national tax systems to reduce their overall tax liability. In particular, Member States are required to adopt rules in the following areas, which are minimum standards:

- Limit to interest stripping: Interest payments are generally tax deductible in the EU. Some groups of companies design their financing in such a way that their debts are allocated to a group company in a high-tax jurisdiction where interest is deductible, while at the same time interest is paid to the lending group company which is domiciled in a low-tax jurisdiction. Under the Directive, net interest which a company may deduct from its taxable earnings must be limited to a fixed percentage based on its gross profits.

- Exit tax rules: Exit taxation is to discourage companies from shifting assets such as intellectual property or patents solely for the purpose of tax avoidance. Assets are often not taxed when they are transferred to a third country. Some companies take advantage of this and shift high-value assets to low-tax jurisdictions to avoid having to pay tax on profits in the EU which would accrue when selling these assets. The Directive requires all Member States to subject assets leaving their territory to exit tax.
- Controlled Foreign Company Rule (CFC): This rule is intended to discourage multinational corporations from shifting profits generated by the parent company in a high-tax jurisdiction to controlled subsidiaries in low-tax jurisdictions. Under this rule, the Member State in which the parent is domiciled may, under certain conditions, tax all profits which the corporation is parking in a low-tax jurisdiction.
- Switch-over clause to avoid double non-taxation: Dividends, investment income and permanent establishment profits entering the EU from third countries are often tax-exempt to avoid double taxation. Some companies make use of this in order to secure double non-taxation for themselves. This Directive provides for a switch-over from the exemption to the credit method, if this foreign income is subject to a tax rate of less than 40% of the domestic corporate tax rate.
- General rule to prevent abuse. Aggressive tax planning seeks to circumvent tax avoidance rules or to develop new tax avoidance strategies which are not covered by these rules. The Directive contains a general provision to prevent abuse under which artificial tax arrangements which are not covered by any provision against tax avoidance can be annulled.
- Rules on hybrid mismatch arrangements: The fiscal-law mismatch between the various EU Member States (e.g. regarding the classification of a financial instrument as equity or debt) can be used for targeted arrangements to gain tax advantages (so-called hybrid mismatch arrangements). In order to avoid double recovery of losses for tax purposes or the granting of tax deductibility of payments without corresponding taxation with hybrid companies or hybrid financings, the legal classification of a hybrid instrument or entity made by the Member State in which the payment originates is to be recognised by the Member State in which the payment is received.

In principle, Member States have until the end of 2018 to transpose the Directive. The deadline for implementing the rules on exit tax and on hybrid mismatch arrangements with third countries has been extended until the end of 2019.

In addition, the EU package contains a Communication from the Commission on an **external strategy for effective taxation** which provides for a stronger and more coherent approach by EU Member States to cooperation with third countries in tax matters (e.g. support for developing countries in tax issues, tax governance requirements for EU funding, EU list of tax havens). The package against tax avoidance also includes a recommendation to implement measures to combat abuse of tax treaties. The Recommendation provides guidance to Member States on how to better protect their tax treaties against abuse in line with EU law through aggressive tax planning. This is also intended to contain the risk of **double taxation** for companies which contribute their fair share of tax revenues.

No agreement has yet been reached at EU level on the **Common Consolidated Corporate Tax Base (CCCTB).** While the Commission had proposed the CCCTB as early as in 2011, it did not succeed in getting the overall package adopted. In October, the Commission then launched a new proposal to implement the CCCTB in two steps. As a first step, a Common Corporate Tax Base (CCTB) is to be created which would be mandatory for groups of companies with annual revenues higher than EUR 750 million. In a second step, an apportionment formula for the consolidation aspect of the CCTB is then to be added (apportionment of the consolidated tax base among the Member States). The system of sharing tax revenues among Member States using the apportionment formula uses three equally weighted factors: payroll and number of employees, assets, and revenue by destination. The European Parliament has been calling for the introduction of a fourth factor, i.e. "data" (collection and use of personal data of users of online platforms and online services). The Commission believes that the CCTB would significantly improve the framework in which businesses in the EU operate. Businesses operating across borders would no longer be faced with 28 different tax regimes, but could calculate their taxable profit using one single system. At the same time, the CCTB could be an effective means against profit shifting and abusive tax planning in the EU.

When it comes to **excise duties**, high shortfalls caused by tax fraud are recorded, in particular as far as VAT is concerned. The current **VAT rules** on B2B cross-border trade in EU Member States date from 1993. They are no longer fit to respond to technological developments and economic globalisation or adequate to prevent VAT fraud within the EU. The resulting tax losses have been estimated at approx. EUR 50 billion annually. VAT fraud affects the EU Member States at varying degrees – the VAT gap ranges from less than 5% to over 40%. Some more heavily affected Member States have requested to apply a reverse-charge mechanism (reversal of the tax burden, which is to be paid by the beneficiary of a service) on a temporary basis, which differs from the general principles of the VAT Directive. For some time now, the European Commission has been advocating a definitive VAT system that meets the needs of the single market.

The 2016 Action Plan on VAT sets out in detail the efforts to create a single EU VAT area, which is simpler and less susceptible to fraud. The European Parliament and the Council agreed that the final system should be based on the principle of taxation in the Member State of destination. Hence, the tax rules according to which the supplier of goods collects VAT from a customer are to be extended to cross-border sales.

In October 2017, the European Commission submitted far-reaching proposals on reforming EU VAT rules which rest on the following pillars:

- Combating fraud: VAT should be levied on B2B cross-border sales within the EU. This type of sale is currently VAT-exempt, creating opportunities for fraud.
- One-stop-shop: Businesses may submit filings and settle payments via a centralised online portal in their own language and based on the same rules, using the same administrative forms as in their home country. Member States then mutually settle and pay VAT directly as is already being done with electronic services.
- Stronger coherence: Converting to the "country of destination principle", according to which the final VAT amount is always paid to the Member State of the final consumer

and corresponds to the tax rate applicable in that Member State. This is what the European Commission, supported by the Member States and the European Parliament, has been promoting for quite a while. This principle already applies to electronic services.

- Less red tape: Simplifying invoicing rules so that sellers can make out their invoices for cross-border sales according to their respective national rules. In the future, businesses will no longer be required to draw up a list of cross-border transactions (“recapitulative statement“) for their tax authorities.

In the view of the European Commission, Member States should treat cross-border VAT revenues like domestic revenues in the common single market. In May 2018, the Commission submitted proposals for detailed technical measures for the operation of a definitive VAT system.