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COMMISSION STAFF WORKING DOCUMENT

Corporate Income Taxation in the European Union

Accompanying the document

**Communication from the Commission to the European Parliament and the Council
on a Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for
Action**

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1. INTRODUCTION

The taxation of multinational companies has come under scrutiny by tax administrations, tax experts and the general public in recent years. More and more evidence suggests that considerable amounts of corporate income from cross-border activities can avoid taxation. The business models of multinational companies have become more complex, intra-group transactions have multiplied and multinationals' integrated value chains make it difficult to determine where profits are created. Governments struggle to determine within the current set of international tax rules which country should tax a multinational's income.

Shifting income and capital across borders can lead to a loss of corporate income tax revenues. Many companies manipulate their internal prices and shift profits to low tax jurisdictions. Digitalisation has made it easier for multinational companies to organise their activities through off-shore financial centres, and to create sophisticated structures for tax planning purposes. While differences in the statutory corporate income rates are one important driver of profit shifting, also the effective tax rates companies face play a crucial role since these rates also reflect preferential regimes and loopholes in national tax bases.

The existence of profit shifting practises is demonstrated in many academic and empirical studies. Although the impact on total tax revenues is hard to measure, it might be considerable.¹ Estimates for the United States find revenue losses of up to 25 per cent of CIT revenue, while research by the IMF (2014) comprising 51 countries concludes that "*the (unweighted) average revenue loss is about 5 % of current CIT revenue – but almost 13 per cent in non-OECD countries*".²

These observations have led to a more general debate on fairness, equity and efficiency in taxation in the light of fiscal adjustment needs.³ Base erosion has become even more relevant in the context of rising concerns on fiscal sustainability following the financial crisis: public debt levels have increased substantially in the EU from around 58% of GDP (EA 65%) in 2007 to a forecasted value of 88% of GDP (EA 94%) in 2015. As a result of the crisis, many governments cut expenditures while increasing taxes, notably on consumption, to consolidate public budgets⁴. The use of several tax planning strategies by multinational corporations has created a debate about their fair contribution to government budgets.

At the global level, the challenges related to the taxation of multinational companies have increased the political pressure to strengthen the international rules of operation in corporate tax matters.⁵ Following the crisis and the increased revenue needs, the OECD proposed an action plan against base erosion and profit shifting to reinforce the current international tax rules and stabilize national tax bases. The OECD project focuses on

¹ For a review of existing indicators and the associated challenges, see OECD (2015).

² See IMF (2014) for further details. Zucman (2014) estimates the loss for the US at 20% of total CIT revenue while the IMF (2014) quotes 25% as a maximum for the US.

³ According to Eurobarometer (2012) 88% of Europeans (EU-27) supported tighter rules on tax avoidance and tax havens http://ec.europa.eu/public_opinion/archives/eb/eb78/eb78_cri_en.pdf.

⁴ For example, the average standard VAT rate has increased by 2 percentage points over the period 2007-2014 in the EU. For a detailed description of tax reforms in Member States, see the Taxation Trends in the European Union 2014 and the Report Tax Reforms in EU Member States 2014.

⁵ The OECD base erosion and profit shifting project (BEPS) was endorsed by the G20. See the G20 leader's declaration after their meeting in Los Cabos on 18-19 June 2012, p. 8, paragraph 48: https://g20.org/wp-content/uploads/2014/12/G20_Leaders_Declaration_Final_Los_Cabos.pdf.

the interaction of different (national) tax rules and tries to detect and close loopholes in the current setup.⁶ The EU fully supports the on-going OECD work in this area and many of the issues addressed by the OECD are of relevance also within the EU and are important for the international competitiveness of the EU enterprises as well.⁷ Also, the EU plays an important role in addressing these questions as it is one of the largest economic players in the world.

At the same time, the problems faced by the EU go beyond the issue of closing loopholes in the existing international setup. Tax avoidance and aggressive tax planning by multinational companies distort price signals in the single market and thereby the allocation of resources. Companies which use tax avoidance are more profitable and face lower capital costs compared to domestic companies. This issue has to be addressed at the EU level to ensure a level playing field for different types of companies.

While introducing unilateral anti-abuse measures by Member States might be a valuable short term solution to fix the most pressing issues, the EU has to make sure that an increase in national anti-abuse measures does not hamper the overarching goals of the single market, the creation of a capital markets union and the overall attractiveness of Europe at the global level. Therefore, the issue has to be discussed from a wider perspective in the EU. With its single market and a common currency in the Euro area, the EU offers unique advantages to citizens and business. The economic integration within the EU has increased welfare of citizens by lowering prices, increasing choices and removing borders. Also, it has helped businesses to access larger markets, tap new sources of finance and allocate their activities according to economic determinants rather than being limited by national borders. This has led to an increased mobility of goods and services and production factors within the EU which is most notably the case for capital. This mobility has improved the allocation of resources. While the integration of markets has made progress, the taxation of income from activities across the EU remains largely a national task. This can lead to frictions in the single market due to tax obstacles. In addition, unilateral action to safeguard national tax bases as currently discussed at the international level could in some cases increase the number of obstacles if not properly coordinated.

The international debate has also renewed the interest in tax competition issues. Some people claim tax competition could be beneficial by creating more efficient corporate income tax regimes and incentivize governments to offer attractive tax and public good bundles. Also, some argue that limiting the power of governments to tax and thereby limiting excessive tax burdens and excessive public spending is beneficial.⁸ Critics argue that it is unclear why competition for a mobile base in corporate income taxation should be justified by the idea of 'disciplining' overall government spending. They argue that democratic institutions like courts of auditors and national parliaments are better placed to control governments' expenditures than competition in one specific tax. Others state that the idea of benefit taxation seems at odds with the reality that multinational companies are able to decrease their tax payments irrespective of what tax and public good bundles being offered. This document does not conclude which level of tax competition is desirable since this is largely a political consideration. It notes however at a purely factual level that the recent developments have

⁶ This debate is by no means new. These issues are discussed at the international level since more than a century. An overview of the early development of the international system in the 1920s can be found in Jogarajan (2013).

⁷ Annex 4 lists the EU initiative and their relation to the different actions in the OECD's base erosion and profit shifting work.

⁸ See box 1 for an overview of the arguments and the literature on this idea.

changed perceptions of the costs tax competition might create for the common good at the national as well as at the EU level. These considerations include the more indirect effect the tax avoidance of a few companies could have on the tax morale of all taxpayers.⁹

While the EU has been active to find solutions to the issues of profit shifting, more remains to be done. Proposals for reforming corporate taxation have been discussed in Europe since at least 1962 with the call from the Neumark Committee to gradually harmonize tax systems in Europe. In the EU, the debate around corporate taxation began to emerge as economic and political integration led to more cross-border activity. The primary focus was on preventing problems which could hamper the development of the single market, such as double taxation and tax discrimination. The Commission has highlighted the issues and challenges of corporate tax systems in an economic union as well as their role for competitiveness vis-à-vis third countries for many years starting with the 1962 Neumark report followed by the 1970 van den Tempel report and the 1992 Ruding report.¹⁰ In 1998 the Code of Conduct for business taxation was established to limit harmful tax competition and identify specific tax regimes considered harmful. In this context, also rules on the application of the State Aid rules to measures relating to direct business taxation were published by the Commission in 1998. In 2001, the Commission presented a Communication identifying concrete steps to eliminate tax obstacles to cross-border trade in the EU. This was followed by 10 years of technical preparation, culminating in the Commission's 2011 proposal for a Common Consolidated Corporate Tax Base (CCCTB). More recently, the fight against tax fraud and tax evasion moved to the centre of European efforts, being at the focus of the 2012 Action Plan against fraud which among others led to an amendment of the Parent Subsidiary Directive to allow Member States the use of unilateral measures against profit participating loans as well as to the establishment of the Platform for Tax Good Governance.¹¹ The transparency package proposed in March 2015 contains a number of proposals to improve transparency and information flows between tax administrations, notably on tax rulings. Some of the policy options put forward to deal with profit shifting could also potentially address the debt bias in corporate taxation stemming from the asymmetric treatment of debt and equity. This issue has indeed become particularly relevant following the financial crisis because it may lead to an excessive leverage and it may prevent the creation of a single integrated European capital market.¹²

⁹ Evidence from behavioural economics shows that fairness (e.g. that the tax administration or the government treat tax payers in a consistent and transparent way) is an important determinant of tax morale. If anecdotal evidence in the public opinion suggests that some taxpayers receive a different treatment or can easily avoid taxes, this might deteriorate the willingness to contribute to public revenues via taxes in general. Alm and Torgler (2006) analyse in an empirical study a number of tax morale determinants.

¹⁰ It is beyond the scope of this document to give a full overview of all contributions to the debate about tax harmonization at the EU level. The main papers after the Neumark report are the Van den Tempel Committee (1970) which called for a classical tax system for all Member States. The Werner Report (1970) proposed tax harmonisation in the context of a monetary union. The 1971 and 1972 Council resolutions called for fiscal harmonisation and in 1975 a proposal from the European Commission suggested to harmonise corporate tax rates in a band between 45% and 55%. The Nyborg report (1979) asked to harmonise tax bases prior to rates. Finally, the Ruding report proposed in 1992 some minimum standards in corporate tax bases and a band for tax rates between 30% and 40%.

¹¹ On the application of Recommendations C(2012)8805 and C(2012)8806, please see Annexes 2 and 3 which provide information on the work of the Platform on Tax Good Governance.

¹² See de Mooij (2011) and European Commission (2015).

While corporate income taxation and capital taxation more generally have become de facto international taxes due to the mobility of the tax base, tax policy and administration remain primarily a national responsibility. All decisions on taxation in the EU are taken unanimously in the Council. This has in practice limited the degree of coordination and harmonization in this policy field in the EU as a whole as well as in the Euro area. With the growing number of Member States, the unanimity rule in the tax area has effectively reduced the chances of progress in legislation to safeguard national tax bases while ensuring a smooth functioning of the single market.

This staff working document gives an overview of the reasons underlying tax competition and its economic consequences in the EU while pointing at options to mitigate the extent of tax avoidance activities. At the root of the problem are the current international rules for the distribution of taxable profits, the increase of capital mobility over the last two decades and the lack of information and transparency on tax policies and enforcement at the international level. The interplay of these factors creates incentives for governments to compete for highly mobile tax bases, notably accounting profits as well as income related to intangible assets, either by creating specific regimes with lower tax rates for some types of income or via a decrease of the headline statutory tax rates. At the same time, multinational companies use these structures as well as unintended mismatches between countries tax systems to decrease their overall tax payments. The discussion of these issues in this document is organised as follows: After this introduction, section 2 presents the results of the stakeholder consultation held in April. Section 3 discusses the empirical evidence and the theoretical arguments concerning the development of corporate income taxes in the EU in the context of international tax competition. Section 4 presents possible options to deal with tax avoidance activities.

In the light of the evidence for tax competition and profit shifting presented, the analysis concludes that three areas of action could be envisaged to tackle the current problems in the taxation of (large) multinational enterprises:

1. The first is an **integrated EU approach to the taxation of corporate income by implementing a common consolidated corporate tax base (CCCTB)** at EU level which would not only replace the current mechanism of taxing corporate profits with a system based on attributing income where the real economic activity takes place as measured by different factors (e.g. the number of employees, the sales and the capital stock), but also eliminate the costly transfer pricing procedures since the tax base would be consolidated at EU level.
2. The second are **measures focusing on the short term goal of stabilizing tax bases** aimed at closing existing loopholes and improve transfer pricing procedures. These measures would also comprise ways to ensure a minimum level of taxation for specific types of income as well as additional transparency measures such as an EU list of tax havens.
3. The third area covers a broader topic and aims at **reforming the EU governance structures in tax matters** to address taxation in a more transparent and effective way.

2. CONSULTATION OF INTERESTED PARTIES

A stakeholder meeting was held on 13 April 2015 to discuss possible actions for inclusion in the Action Plan. All stakeholders agreed that EU action on corporate taxation was necessary and welcomed the Commission initiative. Large business representatives and professional services bodies stated that they strongly supported the existing CCCTB proposal, and emphasised that it was important for them to retain optionality and consolidation. NGOs and Small and Medium Enterprise (SME) business groups stated that although they would largely prefer to retain consolidation, they were happy for this element to be postponed in the interests of moving the proposal along. Both SMEs and NGOs were firm that the CCCTB be made mandatory to prevent profit shifting. The discussion otherwise centred on Country by Country Reporting (CbCR), with NGOs and SME groups arguing for swift progress on adopting public CbCR, while larger businesses and professional services groups supported the need for a full Impact Assessment to be conducted. NGOs also asked for the commission to assess the impact on developing countries of tax avoidance by MNEs based in the EU, including undertaking a "spill-over analysis".

Those Member States which spoke at the event supported making the CCCTB mandatory and supported postponing consolidation. The majority were in favour of focussing discussions in the short term on international aspects on the CCCTB. Several Member States voiced their support for agreeing a minimum effective tax rate, in particular in the context of EU directives. Others reflected that tax rates were an important tool for some countries, and their needs to be taken into account. On CbCR, the Member States which spoke supported the need for an Impact Assessment on the costs and benefits of the various options. Member States stressed that the Action Plan should also reflect the need to build on the advantages of the Internal Market and provide incentives for businesses to grow. In particular, many Member States were interested in improving the Arbitration Convention.

3. TAX COMPETITION IN THE EUROPEAN UNION

3.1. The Root of the Problem: Where are Profits taxed?

Tax competition – broadly defined as the uncooperative setting of taxes where a country is constrained by the tax setting behaviour of other countries¹³ – is mainly discussed in corporate income taxation.¹⁴ The reason is that governments consider that they are competing with this tax for internationally mobile resources often connected to multinational companies and these are usually taxed as corporations. The two mobile resources are (1) real investments (foreign direct investment) and (2) book profits (taxable profits attributed to a country according to the current system of separate accounting and arm's length pricing).¹⁵

¹³ See Devereux and Loretz (2013).

¹⁴ There are other examples of tax competition for example in the area of the income taxation of very high incomes (e.g. sports stars as analysed in Kleven et al. (2013)) or in cross-border shopping (for example differences in consumption taxes as analysed in Nielsen (2001)). However, it is usually considered to be limited to relatively small groups of employees or consumers compared to the extent of tax avoidance observed in corporate taxation.

¹⁵ The separation between real investment and book profits also seems to serve as rough benchmark in what is considered to be harmful tax competition. Generally, preferential regimes are in their nature more related to attraction of book profits. In practice it is however difficult to draw an exact line between these types of competition.

3.1.1. *The Basic Mechanism*

In an ideal world, the profits derived from the investment of a multinational company in a specific country could be clearly observable and attributable to real activity in that country. In reality, the distribution of taxable profits poses considerable problems. When the economic activity of a company or a group is taking place in two countries the question arises how to divide the taxable profits from the activity between two jurisdictions while at the same time assuring that there is no double taxation (or double non-taxation).¹⁶

The system of international coordination of taxation assigns taxable profits based on the idea that economic activity should serve as the measure for distribution. To determine the economic activity in a tax jurisdiction the subsidiary of a multinational firm is for tax purposes treated as a single company. This company uses separate accounting with arm's-length pricing for intra-firm transactions. A system of bilateral tax agreements is in place to avoid double taxation. The current system builds on the work of the League of Nations in the 1920s and that of the OECD after the Second World War.

The bases for the current distribution of taxable profits are the source and the residence concepts.¹⁷ The basic idea is that the country of source – the country where an international company (a subsidiary of a multinational) produces and exchanges goods and services with national companies and households – has the right to tax the profits from these activities. The country of residence – where the owner of the company resides (either individual shareholders or another company) – has in contrast the right to tax the world income of its resident namely income in the form of dividends or interest.

3.1.2. *The Challenges due to Globalization*

The distribution mechanism has come under pressure due to the changes in the economic and business environment over the last decades. For source countries, notably when they are highly integrated internationally as is the case for EU Member States, the activities of hosted companies are not limited to national borders. Inputs are imported from other countries and not limited to national suppliers. Products and services produced are exported and not only serve the market where a company is a tax resident. The same holds true for the payments to owners which are spread over different countries. These payments can either be transformed into interest or dividends or be diverted across countries to minimize tax burdens. On top of this, source and residence based taxation also overlap and the same company can have both source and residence characteristics in one country. Graph 1

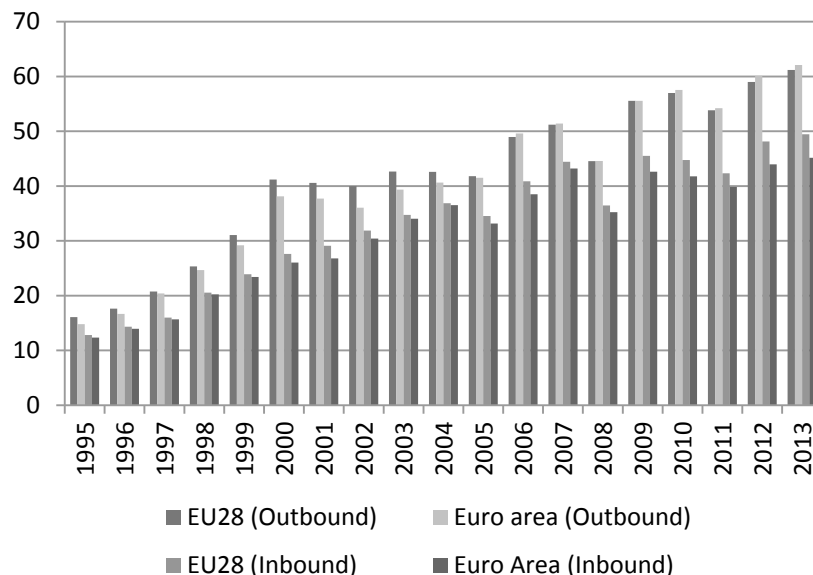
¹⁶ For a discussion of the current issues with the international tax rules see Devereux and Vella (2014). The basic problems are by no means new. Seligman (1895) describes this problem by saying that „*We live in an age of industrial complexity and differentiation. In former times property rights were simple, and the little capital that existed was largely owned by the producer. To-day not only does the same capitalist invest in different enterprises, not only is the producer often dependent for a part of his capital on sums that belong to others, but the old geographical unity has been dissolved, and there is no necessary connection between the residence of the capitalist and the place where his capital is employed. A system of taxation, therefore, which may have been perfectly just under the older and simpler conditions, may now be entirely inadequate because of the failure of government to take account of these new complications in property rights.*“ Jogarajan (2013) notes based on this quote that the basic issues remain essentially the same in today's global discussions about the taxation of multinational companies.

¹⁷ For a more detailed discussion on the limits of the current system see Schön (2009). For a description of the current system see the OECD Model Tax Convention.

illustrates the increased importance of cross border activities using data on foreign direct investment stocks between the EU, the Euro Area and the rest of the world between 1995 and 2013. The steep increase in stocks since 1995 and during the first decade of the 2000s underlines the increased importance of multinational company activities.

The growing importance of intangible assets and the digital economy has further increased the pressure on national tax systems. The growing share of intangibles assets (patents, brands, firm-specific knowledge and technologies) in the value creation of multinational companies has increased tax competition. While the (re)location of these assets is easier than for tangible (e.g. machinery, factories) assets, estimating their true economic values and the real values of payments for their use is very complicated and sometimes even impossible given the lack of comparable third party transactions. Despite the fact that the digital economy or more precisely the overall development of the internet and communication technologies plays an important role in this, the view of most experts is that the problem is not limited to one sector but is of a more general nature. Solving the overall problems will therefore also address the concerns regarding the digital sector.¹⁸

Graph 1: FDI stocks relative to the rest of the world, EU-28 and Euro area, 1995–2013



Source: UNCTAD (2014)

3.1.3. The Tax Policy Reaction

As a consequence, Member States struggle to tax profits, which derive from economic activity carried out by international companies on their territory. To put it differently, the international taxation rules struggle with distributing taxable profits based on the notion of economic activity since it has become more and more difficult to trace the value creation

¹⁸ For a detailed account of the role of taxation and the digital economy for tax competition see the report of the Commission Expert Group on Taxation of the Digital Economy (2014). The report states that "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." http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/good_governance_matters/digital/report_digital_economy.pdf.

process with a territorial approach. Countries compete with each other by creating regimes that attract mobile tax bases. The basic problem is that jurisdictions that compete for capital via their tax system do not take into account the fiscal externalities their actions create in other countries. Although the results of the literature are not conclusive, this lack of coordination might ultimately lead to welfare losses. Box 1 provides a brief review of the theoretical arguments.

The developments have led to a typical tax reform described as *tax-rate-cut-cum-base-broadening* where governments have decreased corporate tax rates while broadening the base to mitigate revenue losses.¹⁹ Since profit shifting is largely driven by tax rate differentials (see Box 2 for a more detailed explanation), this policy is from a national perspective a reasonable policy response to the lack of coordination at the international level.²⁰ Graph 5 shows the strong decrease of statutory rates since 1995 in the EU and third countries and evidence for base broadening policies is presented in Annex 1. It should be noted that base broadening as such is not harmful. Quite to the contrary, in some areas tax policies promoting broad bases and lower rates are in fact recommended since they tend to minimize the distortionary effects of taxation.²¹

¹⁹ Nevertheless, base broadening has been less common than rate reduction. See the Annex to this SWD.

²⁰ The basic theoretical model for the observation that profits shifting is driven by tax rate differentials can be found in Haufler and Schjelderup (2000). Empirical evidence for this profit shifting via transfer prices is reported in section 3.2.3.

²¹ For example, the Commission argues in favour of such policies in the annual growth survey with a focus on reducing exemptions and loopholes. A case in point are exemptions in value-added taxation and tax expenditures in personal income taxes and corporate taxes.

Box 1: Tax competition and welfare

This Box gives an overview why the differential treatment of some forms of companies and capital might be a concern from a welfare point of view and why it could be even beneficial in some cases.

Tax competition can lead to an undersupply of public goods. In general, if countries engage in tax competition to attract perfectly mobile capital, a source-based tax on capital may trigger a capital outflow and the burden of the tax would be then entirely shifted onto the local production factors. Ultimately, this would lead to an under-provision of public goods. In this case, tax harmonization would be always beneficial. A coordinated increase of the taxation of capital would indeed determine an increase of public spending towards the efficient levels leading to an unambiguously positive effect on welfare.

Tax competition may also tilt the choice of the tax mix with a higher burden borne by the immobile production factor. This theoretical prediction that capital mobility leads to a situation where the economic incidence of taxes on mobile production factors will ultimately fall on the immobile factor is supported by the empirical evidence presented below. An interesting question in this context is whether the new international rules for information exchange will have an impact on the mobility of the capital tax base.

Tax competition may distort the allocation of capital between countries of different size. Where countries differ in size as measured by the number of inhabitants - not because these individuals differ in income or preferences – large countries tend to have higher rates than smaller countries. The reason is that large countries can affect the after-tax return to capital while small countries cannot. The result will be an inefficient allocation of capital between large and small countries. This reinforces the case for coordination or harmonization, but it also makes coordination more difficult from a political point of view because small countries benefit relatively more from tax competition in terms of capital inflows and higher service and public spending than large countries.

Another welfare cost of tax competition is related to its effects on public redistributive policies. These policies could be characterized as insurance against specific risks such as unemployment or illness. If tax competition undermines the ability of governments to provide such insurance this will have social costs.

The strong predictions of the standard models of tax competition have been refined by numerous other contributions in the literature. Overall, the effects of tax competition on the provision of public goods and the size of public sector, the tax system, and ultimately on welfare are complex and depend on many elements.

Relaxing the assumption of a fixed capital stock introduces into the picture the links between a certain economic area and the Rest of the World. In the standard models of tax competition, the capital stock is assumed to be fixed. In reality, the supply of capital is elastic. Therefore, a reduction of capital taxation will not only attract capital from other jurisdictions in an economic area, but also from the Rest of the World. This implies that the aggregate efficiency costs of tax competition will be in general reduced with respect to the standard models. These considerations are directly relevant for the European Union. The most obvious implication is that in tackling the "internal" tax competition process, it is important to keep in mind the "external" dimension as well, in order to avoid hampering the attractiveness of the EU for investment from the rest of the world.

Important refinements of the standard models consider the case of imperfect competition and the possibility of economic rents, both firm- and location-specific. In general, standard results discussed above still hold if these rents are firm-specific. Indeed, in this case there will be the incentive for the governments to engage in tax competition to attract the firms generating these rents. This is not the case anymore for location-specific rents. Following this line of reasoning, smaller countries could be more active in tax competition if they have a little potential for location-specific rents.

In the new geography models, location specific rents derive from agglomeration economies. These models provide a very different view of tax competition. The reduction of production costs due to agglomeration leads to spatial concentration of production facilities in "core countries" whose residents demand high levels of public services. This allows higher tax rates on capital income because agglomeration economies generate rents that can be taxed. Therefore, in these models tax harmonization is in general not desirable. For instance, core countries would have to reduce public services to inefficiently low levels.

Box 1: Tax competition and welfare (continued)

Profit shifting may have different effects on tax competition for investment. Profit shifting may strengthen tax competition, since countries will be concerned about the revenue losses that may derive from it. But it may also reduce tax competition by decreasing the sensitivity of FDI to corporate taxation (see Sec. 3.2.2). Policymakers may therefore face a trade-off in dealing with tax avoidance and profit shifting. On the one hand, they may want to secure tax revenues as much as possible by setting in place anti-avoidance tools. On the other hand, they may want to keep or increase the attraction of the country for multinationals. One obvious way to deal with this trade-off could be differentiating the taxation of multinationals and domestic firms, recognizing the former are more mobile than the latter. This could be achieved not only directly, but also indirectly if tax planning devices are available *de facto* only to multinationals via for instance issuing specific regulations, rulings, or lax enforcement.

In some cases tax competition could even have welfare-improving effects. The most important early contribution is Brennan and Buchanan (1980). Their basic idea is that without tax competition the size of the public sector would be excessive. Tax competition would be then beneficial because it would limit the tendency of governments to the overexpansion. The incentive to an overprovision of public goods could derive specifically from the fact that capital is not perfectly mobile for the simple reason that once it is installed it is costly to be moved. Therefore, government may try to tax it. Tax competition may limit this incentive.

The competition for mobile capital has also created strong incentives to create preferential regimes where governments tax specific mobile bases at a lower rate than domestic bases. The reason is that in order to limit revenue losses it is attractive to tax mobile bases lighter than immobile (domestic) ones. In economic terms, a government sets the tax rate in response to the elasticity of the tax base.²² The easier the tax base moves out of the country, the lower the tax rate in the preferential regime will be. The existence of preferential regimes was limited by international policies aiming at reducing this type of regimes generally considered as being harmful forms of tax competition.²³ One should note though that removing these regimes increases the pressure to compete for tax bases with the statutory rate. The reason is that the government loses one policy tool when these regimes are abolished and will need to readjust its overall system leading to an overall lower taxation of corporate profits irrelevant whether they are mobile or not.

²² The basic theoretical argument for this observation was made in a very clear way by Keen (2001). He concludes, "*preferential regimes may serve a useful strategic purpose in enabling countries to confine their most aggressive tax competition to particular parts of the tax system.*"

²³ The prominent example at the EU-level is the Code of Conduct for business taxation.

Box 2: Profit shifting

Multinational companies can exploit differences in tax rates by shifting profits from a high tax to a low tax country. The gain from shifting profit is the tax rate differential. If the tax rate in country A is 30% and the tax rate in country B is 5%, the gain for each Euro taxable profit shifted is 25 cents. There are different ways of shifting profits. The most common are transfer price manipulation, intra-firm debt shifting and intellectual property location.

Transfer price manipulation occurs by manipulating the price of cross-border deliveries, services and other transactions between related companies. The transfer price is a cost to the company receiving the delivery or service and reduces the profit of that company. On the other hand, it is an income to the providing company and it increases the profits of that company. Therefore a high transfer price leads to low profits in the receiving company and high profits in the providing company. If profits are taxed at a lower rate in the country of the receiving company, a low transfer price can reduce the total amount of payable tax without changing total pre-tax profits. Although transactions between related companies should be priced as if they were concerning a third party (arm's length principle), there is some flexibility in the methods and imprecision in the data used for determining transfer prices. Also there is some room for related companies to structure their transactions. This flexibility can be used by multinational companies to reduce the amount of payable tax. The mechanism is illustrated in the following table:

	Base			Alternative A		
	Parent (country B)	Subsidiary (country A)	Total	Parent (country B)	Subsidiary (country A)	Total
Turnover	100	70	170	100	60	160
Costs	70	50	120	60	50	110
Profit (before tax)	30	20	50	40	10	50
Tax rate	5%	30%		5%	30%	
Payable tax	1.5	6	7.5	2	3	5

In the base scenario, a parent company in country B sells finished products for 100 units. It buys intermediary products from a subsidiary in country A for 70 units. This is the arm's length price, consisting of a cost of 50 and a profit mark-up of 20. The parent has no other costs. Now, the total pre-tax profit of the multinational is the sum of the profits of the parent, 30 and those of the subsidiary, 20. In total, the pre-tax profits are 50. 30 is taxed at 5% and 20 is taxed at 30%, leading to a total payable tax of 7.5. If there are no easy comparable goods to determine the arm's length price of the intermediary product, the company could change the conditions of delivery or argue for a lower mark-up reduce the price of the intermediate product to 60 (Alternative A). While total pre-tax profits remain unchanged, the profits of the parent are increased to 40 and the profits of the subsidiary are reduced to 10. A profit of 10 has been shifted from the subsidiary to the parent and, as a consequence, from high-tax country A to low-tax country B. As a result, the total payable tax is reduced by 2.5 to 5.

Another mechanism for cross-border profit shifting is debt shifting. Multinational companies have large freedom in establishing intragroup financial relations. By using internal loans instead of internal equity, they can convert income streams from dividends to interest. As dividends are usually taxed in the source country and interests in the residence country this leads to a shift of profits. This is illustrated in the table overleaf.

Box 2: Profit shifting (continued)

Assume the same base scenario as in the table above. The parent company fully owns the subsidiary company. The subsidiary is fully financed by equity provided by the parent company. Net profits from the subsidiary are repatriated to the parent. According to the DTC between country A and country B dividends from country A are exempt from additional taxation in country B (participation exemption).

	Base			Alternative B		
	Parent (country B)	Subsidiary (country A)	Total	Parent (country B)	Subsidiary (country A)	Total
Earnings (before interest and taxes)	30	20	50	30	20	50
Interest	0	0	0	15	-15	0
Taxable Profit	30	20	50	45	5	50
Tax rate	5%	30%		5%	30%	
Payable tax	1.5	6	7.5	2.25	1.5	3.75
Net profit	28.5	14	42.5	42.75	3.5	46.25
Repatriated dividend	14	-14	0	3.5	-3.5	0
Net profit after repatriation	42.5			46.25		

In this case the payable taxes are identical to the ones in the previous example: 1.5 in country A and 6 in country B. Now consider an alternative situation (Alternative B) in which the subsidiary still is fully financed by the parent company, but part of this financing has taken the form of a loan. Assume that the value of the loan is 150 and the yearly interest to be paid 15. Note that this internal loan does not have to have consequences for the external financing of the multinational company. Now, the transfer of income from the subsidiary to the parent takes two forms: interest and dividends. The interest paid from the subsidiary is deductible in country A and taxed in country B. The dividend is taxed in country A and exempt in country B. So, by increasing the debt of the subsidiary, the multinational has shifted 15 units of profits from country A to country B. This leads to a reduction of payable tax from 7.5 to 3.75.

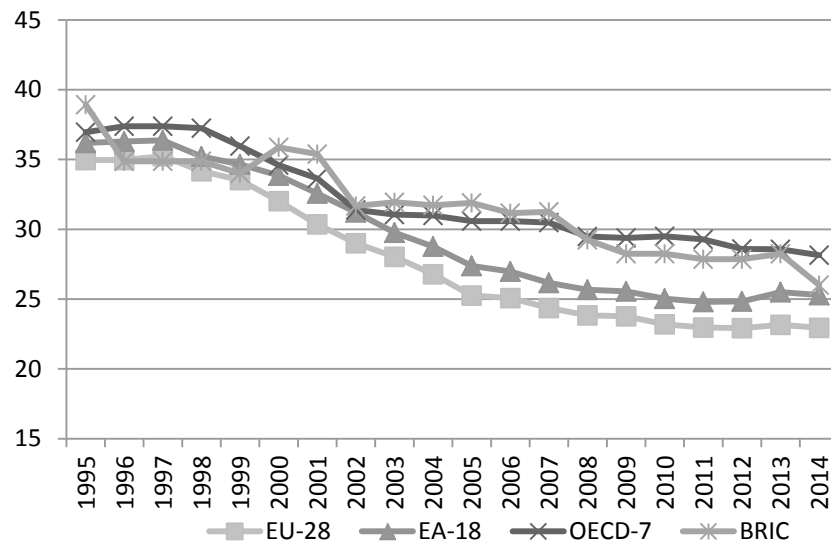
The mechanism of profit shifting through the use of royalties is very similar. If the subsidiary company is using intangible assets of which the property rights are in the hand of the parent, a stream of royalties from the subsidiary to the parent will emerge. This stream will reduce profits in the source country (country A) and increase them in the residence country. An arm's length price of these royalties is almost impossible to assess.

3.2. Empirical Evidence

3.2.1. Development of Corporate Income taxation

The dynamics of the statutory and effective tax rates provide insights about the tax competition process.²⁴ The decision of a multinational company to engage in profit shifting depends on the difference between the statutory tax rates between countries.²⁵ This difference is the gain that can be obtained by shifting profits from a high to a low tax jurisdiction. By contrast, other tax rate measures such as the effective average tax rate (EATR) impact the decision where to locate an investment, while the size of an existing investment depends on the effective marginal tax rate (EMTR) in a country. In line with the *tax-rate cut-cum-base-broadening policy* described above, Devereux and Sørensen (2006) find a clear downward trend in the statutory tax rates for the EU-15 and G-7 countries. They also find a decline of the EATR since the 1980s and a certain stability of the EMTR for the period 1982-2001, followed by a reduction in the 2000s. These developments are consistent with two explanations for tax competition which are not mutually exclusive. First, the decrease of the statutory rate is due to the existence of tax competition for mobile book profits and countries reduce rates to be less exposed to profits shifting. Second, the decrease in the EATR is a result of tax competition for mobile firms (investments) since the decision on where to locate is based on the average tax payment on all profits generated by the project. Graph 2 shows the development of the statutory tax rate for more recent years and confirms this downward trend until the beginning of the crisis when statutory tax rates levelled off. Table 1 gives the values for other tax rate measures which show again the same pattern as identified by Devereux and Sørensen (2006).

Graph 2: Statutory CIT rates, 1995-2014

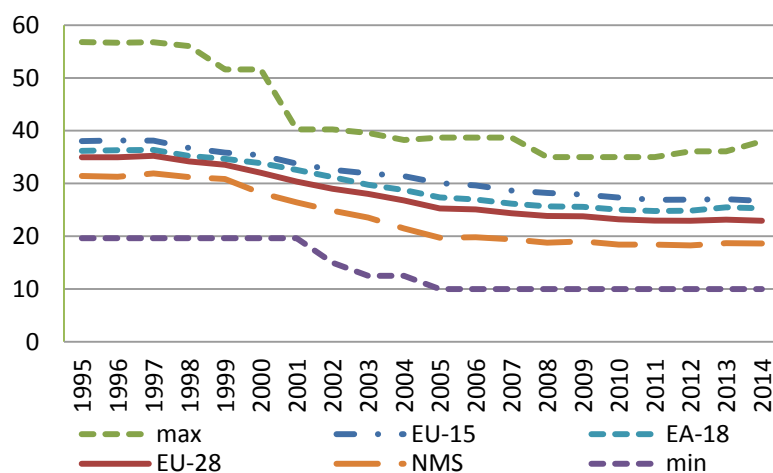


²⁴ There exists a large empirical literature focusing on tax competition. According to the survey by Devereux and Loretz (2012), the studies can be classified in three groups. Some papers look at the dynamic of tax rates and tax revenues; other papers analyse the tax rates and tax revenues of a country based only on factors from that country; finally, some studies try to assess the extent to which the choices of tax rates in a country depend on the choices in other countries.

²⁵ It should be noted that while the difference in statutory tax rates are one piece of evidence for tax competition, differences in the effective rates are equally important. Effective rates capture not only the existence of varying tax rates but also – and in some cases even more importantly – the existence of loopholes and preferential regimes.

Source: Taxation Trends in the European Union (2014)

Graph 3: Statutory CIT rates, maximum EU-28, unweighted averages EU-28, EA-18, EU-15 and NMS, minimum EU-28, 1995-2014



Source: Taxation Trends in the European Union (2014)

The development of the average statutory rates in the EU masks the fact that there are considerable differences between Member States. Graph 3 shows the average rate in the EU as well as the lowest and the highest statutory rates. It shows that the discrepancies in terms of rates are substantial. In 2014, the highest rate is 38 % in France and the lowest rate is 10 % in Bulgaria. The graph also shows that while there was some convergence in rates at the beginning of the millennium, this process seems to have come to an end and rates are even diverging. It should be noted that low statutory rates are not an issue as such. To the contrary, lower rates can also be considered as being investment and growth friendly. The point of the analysis here is to show that a lowering of rates has occurred in many countries. In this document there is no evaluation or consideration on what statutory tax rate level is optimal.

Table 1: Change of average CIT rate, effective average tax rate, effective marginal tax rate, 1998 – 2014 in percentage points

	1998-2000	2000-2005	2005-2010	2010-2014	Total 1998-2014
CIT rate ²⁶	-2.0	-6.1	-2.1	-0.3	-10.4
EATR	-1.7	-4.3	-2.0	0.1	-8.0
EMTR	-1.9	-1.4	-2.5	0.8	-4.9

Source: ZEW(2014) and Commission services

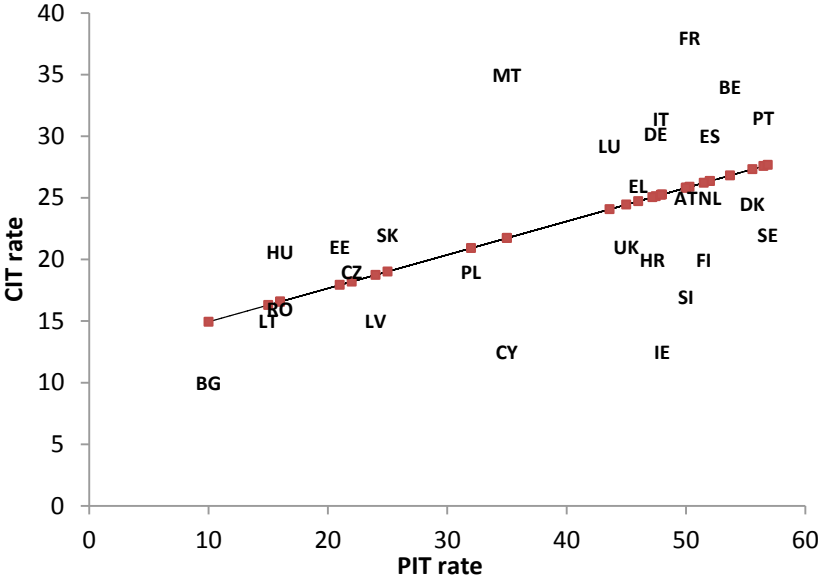
The relative stability of statutory and effective tax rates in Europe over the last five years does not necessarily imply reduced tax competition. Recent data in table 1 show a slower decrease of tax rate indicators and a certain stability of the average statutory tax rates and forward-looking effective tax rates at the EU-level after the crisis.²⁷ Although the

²⁶ To keep the table consistent, in this table CIT rate data from ZEW are being used. These differ slightly from those published in Taxation Trends in EU-Member States.

²⁷ See also Annex 1 to this Staff Working Document.

stabilization of rates might be interpreted as less intense tax competition, this development can also be explained by other factors. Indeed, the decrease of the CIT statutory tax rates has some limits for several reasons related to the (domestic) functions of CIT as described in box 3. First, if the corporate tax is considered as a backstop for personal income tax and a withholding tax for capital income, by decreasing the CIT rate the tax avoidance incentives to re-characterize personal income as corporate income are strengthened with possible negative consequences on total tax revenues. Graph 4 illustrates the correlation between the two rates. Second, the CIT covers not only mobile firms and their profits, but also immobile (domestic) firms and profits. For this reason there is an incentive for governments to create preferential regimes with lower rates for mobile profits while applying the higher headline rate to domestic profits. However, this policy can only be applied within the limits of the Code of Conduct and the State Aid rules. As a consequence, tax competition via the headline rate may increase, if preferential regimes are not allowed. Finally, there could be political constraints for the reduction of the tax rate on corporations, especially given the strong political argument that corporations ought to pay their fair share of tax.

Graph 4: Correlation between top CIT and PIT rates in 2014



Source: Taxation Trends in the European Union (2014)

Box 3: Why corporate income is taxed.

Why do governments generally tax corporations if the corporate income tax creates numerous problems?

Corporate taxes have to be paid by real people meaning either by shareholders via lower returns, by employees and managers via lower wages or by consumers via higher prices. Who in fact bears the burden (the economic incidence) of the tax is the subject of extensive research, and evidence suggests that - in line with tax competition theory predictions - immobile factors such as labour carry the economic burden at least partly. The question then arises why not to tax directly the different stakeholders in a company instead of levying a distorting tax on a legal entity?

There are a number of political and economic explanations for the use of corporate income taxes as a revenue raiser, notably its function as a backstop to the personal income tax. The most important reason is related to a purely domestic function of the corporate income tax, namely that it serves as a backstop to the personal income tax. Governments have not only an incentive to keep the corporate income tax, but also to make sure that the difference between the corporate tax rate and the personal income tax rate is not too large. The reason is that there is otherwise an incentive to reclassify labour income as capital income to reduce the tax burden. Slemrod (2004) shows empirically that the backstop function is an important driver of the corporate income tax rate. Graph 4 shows the correlation between corporate and personal income tax rates for the EU member states for 2014 that is in line with the empirical findings in the literature.

Another important reason for corporate taxation is based on an administrative argument where the corporate tax serves as a withholding tax on capital income at source. The taxation of capital income at source (i.e. at the level of the company) is an effective way to ensure that shareholders pay capital taxes. It should be noted that this does imply anything about the economic incidence of the tax. The idea is rather that in a tax system with a comprehensive tax base a withholding tax at the corporate level might be easier to enforce than taxing the capital income at the shareholder level.

A related argument is the popular view that corporate income taxes should be part of a progressive tax system. While the relation between the corporate income tax and the overall progressiveness of the tax system is not clear (from an economic perspective progressivity should be implemented in the personal income tax which also comprises capital income), this idea is popular and also politically appealing. Here again the issue of who bears the burden of the corporate income tax is important. One could argue that the low taxation of some corporate profits can increase gains for specific groups for example via higher capital gains and therefore higher assets. While clear evidence on this particular link is missing, the fact that high wealth households hold the largest share of financial assets might raise distributional concerns.

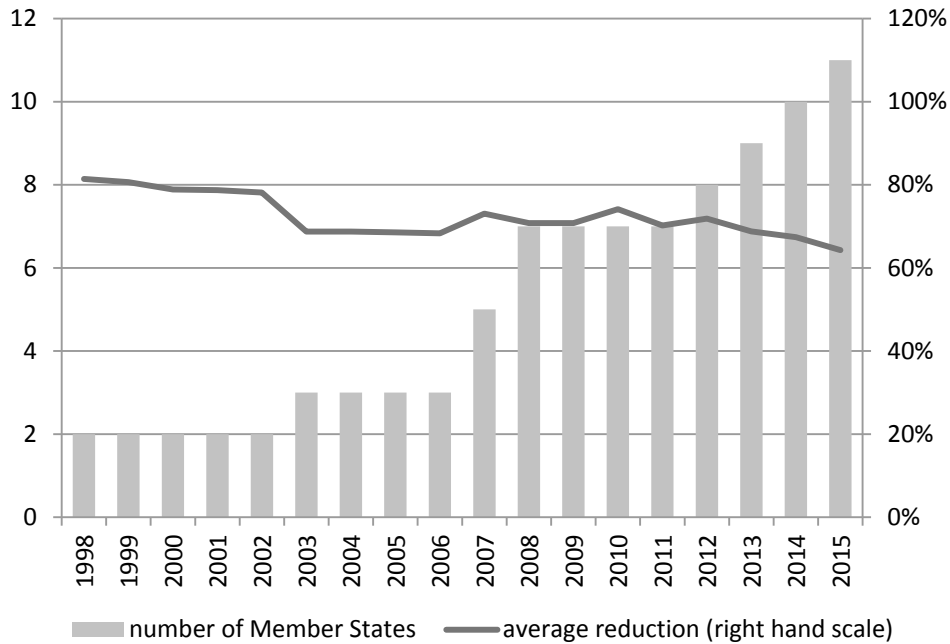
The tax payments of corporations have the character of a benefits tax. This argument states that companies benefit from the provision of public goods by the governments such as public infrastructure, a legal system and the provision of a specific legal form for companies as well as the availability of skilled labour. Since companies use these resources, the argument goes, they should also contribute to its financing. While the argument is very compelling, it is less clear why companies should contribute based on profits since also a loss making company uses these public goods. Nevertheless, the benefit tax is usually considered one reason for taxing corporates.

The corporate tax falls at least partly on economic rents. Taxing pure profits (only) is economically efficient since a pure profit tax collects revenues without taxing an investment at the margin. In reality, corporate income tax systems do not meet this objective, unless the tax base is calculated based on cash flows. While most CIT systems also burden marginal investment, they do at least partly also fall on pure economic rents.

Limits to a decrease of the headline statutory tax rates may reinforce the incentives for countries to enact preferential tax regimes at the boundaries of what is and what is not allowed under rules of the Code of Conduct and to attract profits and multinationals by issuing specific regulations and by rulings, allowing *de facto* mobile firms the reduction of the tax burden. The *standard* forward-looking effective tax rates do not reflect preferential tax regimes, specific regulations and rulings. This may explain the stability of the average statutory tax rates and forward-looking effective tax rates. Graph 5 shows with the example of patent boxes that the levelling off of tax rates since 2007 has been accompanied by an increase of the regimes providing lower tax rates for profits from these sources.²⁸

²⁸ A patent box is a company tax regime which offers a lower tax rate for income from various types of intangible property (IP), such as royalties from patents. The reference to a 'box' comes from the idea of

Graph 5: Number of Member States offering IP boxes and average reduction of rates



Source: Joint Research Centre - TAXUD

Empirical studies focusing on the determinants of corporate tax systems such as globalization, capital mobility and strategic interaction between governments show evidence of tax competition. The main theoretical prediction here is that increasing globalization and capital mobility should put a downward pressure on source-based taxes on corporate income. In line with this prediction, there appears to be a statistical significant negative relationship between forward looking effective tax rates and statutory tax rates and measures of openness.²⁹ A more direct way to test for tax competition is to look directly at the strategic interaction between tax variables set by different countries. Also these studies generally confirm the existence of tax competition. For instance, Devereux et al. (2008) focus on OECD countries over the period 1982 – 1999 and find evidence of strategic behaviour both for statutory tax rates and effective marginal tax rates. Interesting empirical evidence does exist for the strategic interactions between European countries highlighting the role of the small countries located in the centre of Europe and of the new Member States.³⁰

At first sight, it is therefore surprising that the revenue contribution of CIT at the aggregate level has not changed significantly in recent years. In 2012, on average 6.5% of tax revenue was collected from corporations in the EU-27 (2.6% of GDP). Graph 6 shows the development of this share for the EU-27 and illustrates that movements in revenues are due to the pro-cyclicality of the tax. However, this stability should not be misinterpreted as if tax competition had no revenue impacts. The negative impact on revenues has been

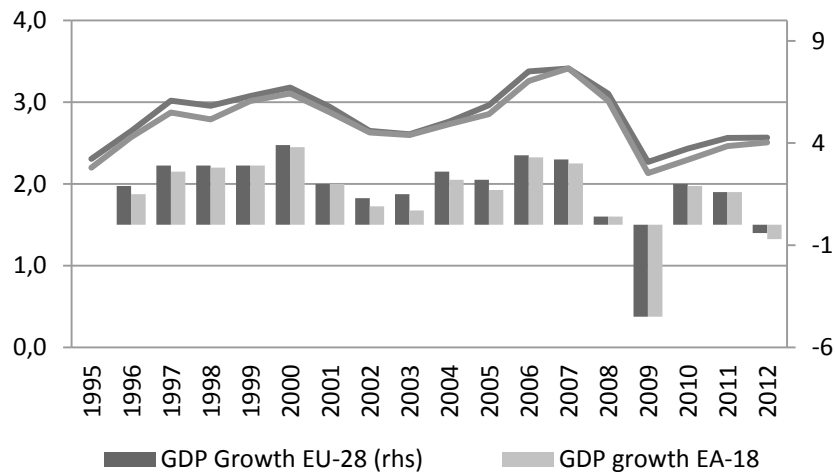
royalties being separated from the rest of the corporate income of the company and given preferential treatment.

²⁹ See for instance Bretschger and Hettich (2005), Schwarz (2007) and Loretz (2007).

³⁰ See Redoano (2007), Chatelais and Peryat (2008), Crabbé and Vandebussche (2008) and Cassette and Paty (2008).

reduced by a number of other factors. First, the base broadening has partly offset the impact of lower rates.³¹ Second, incorporation has increased and this increased the overall base.³² Third, the share of capital in income has increased since the beginning of the 1980s.³³ Lastly, relatively low interest rates in recent years had limited the interest deductibility from the corporate tax base which also had a base broadening effect. These effects do not only explain the stability of tax revenues, they indeed raise the question why the share of corporate taxes in total revenue has not increased over time.

Graph 6: CIT revenues to GDP, GDP growth, EU-27, EU-18, 1995-2012



Source: Taxation Trends in the European Union (2014)

Tax competition will have an impact on the allocation of capital and profits across jurisdictions. These effects will depend on the sensitivity of these variables to tax differentials across countries. Empirical evidence provides insights about the magnitude of these effects. This empirical evidence will be discussed in the following paragraphs. Section 3.2.2 will discuss the relation between the allocation of physical capital and corporate tax rates. Section 3.2.3 will go into profit shifting and its responsiveness to these rates.

3.2.2. Mobility of capital

It is commonly agreed that capital has become more mobile over time and notably with the introduction of the Euro. Capital flows have increased substantially over time. In the EU, on average outbound foreign direct investment (FDI) as a percentage of GDP was equal to 0.64% in the 1970s, 1% in the 1980s, 2.6% in the 1990s, 4.9% in the period 2000-2007; it has decreased to 2.8% in the period 2008-2013 as a consequence of the crisis.³⁴ There are

³¹ Base broadening may have been the result of both deliberate policies (e.g. reduced investment tax credits and depreciation) and the increase of profitability in the corporate sector due for instance to globalization (see Becker and Fuest, 2007) and to the rising share of the financial sector in the economy (see Devereux et al., 2004; Auerbach, 2007). Restricting the deductibility of interest payments is one example for base broadening.

³² See De Mooij and Nicodeme (2008) for empirical evidence of the effects of income shifting from the personal to the corporate tax base.

³³ The development of the capital share and the labour share in income is analysed in Karabarbounis and Neiman (2013). They find that the global labour share of income has decreased while the capital share has increased. Among other reasons, notably changes in technology and relative prices of investment goods have induced firms to shift from labour to capital use.

³⁴ Source: UNCTAD (2014).

moreover clear market signals pointing to a high degree of capital mobility; for instance the equalization across markets of the interest rates on deposits with similar features is a clear indication in this sense. As regards the effect of the monetary union, Petroulas (2007) provides econometric evidence that the introduction of the Euro increased inward FDI within the Euro area by about 16%, from Euro Area members to other member states by 11% and from non-Euro member states to Euro Area members by 8%.³⁵

The correlation between domestic savings and investment indicates increasing capital mobility. The "saving retention coefficient" – the part of domestic savings which is invested domestically – seems to be decreasing over time, consistent with increased capital mobility. For European countries these coefficients are much lower than the non-OECD countries and have declined over time more rapidly.³⁶

Econometric evidence shows that FDI is sensitive to corporate taxation and that the sensitivity may have increased over time. This is in line with increased capital mobility. De Mooij and Ederveen (2006) find that decreasing the host country's tax rate by one percentage point would increase FDI by between 2 and 3.9% depending on the study characteristics. Feld and Heckemeyer (2011) find lower effects, although still statistically significant.³⁷ Furthermore, also the location decision of multinational companies' investments is affected by taxation.³⁸

Empirical evidence also suggests that a large share of the burden of corporate taxes is shifted to immobile factors. Again, this is in line with increased capital mobility. Indeed, the theoretical literature provides clear predictions for the incidence of a source-based tax on capital: the more mobile the capital is, the lower the tax burden on capital will be, since this burden will be shifted onto other production factors.³⁹ Measuring the incidence of taxation is however difficult and the results should be interpreted with caution. However, the existing studies provide indication that capital is indeed very mobile. Arulampalam et al. (2008) find for the period between 1993-2003 that in France, Italy, Spain and the UK about 60% of the burden of the corporate income tax is borne by labour in the short-run and that labour bears all the burden of the tax in the long-run. This means that for each additional Euro of corporate tax, wages decrease by 60 cents. Fuest et al. (2013) find an incidence of 77% over the period 1998-2008 for Germany. Lower estimates for Germany are provided by Dwenger et al. (2011). They find an incidence of between 19% and 29% relying on data for the period 1998 and 2006.

Note that the possibility of income shifting by multinationals tends to reduce the mobility of real capital (FDI). Tax avoidance could make FDI less sensitive to tax factors

³⁵ Schiavo (2007) confirms these results in a different research setup.

³⁶ See Feldstein and Bacchetta (1991), Obstfeld and Rogoff (2000) and Zodrow (2010).

³⁷ Both studies are so called meta-studies. This means they summarize the results of numerous empirical studies using statistical tools to derive a single estimate out of from all the estimates considered in the meta approach.

³⁸ See Barrios et al. (2012) for an analysis of the impact of withholding taxes on the investment location decision. The authors also found that the complexity and multiplicity of bilateral country-tax rules magnifies the tax savings international corporations can make through FDI decisions. A similar result was found by van 't Riet and Lejour (2015).

This concern was also raised by Mario Monti in the report "A new Strategy for the single market" which was prepared upon request of the European Commission. The report was published in 2010. Monti stresses that the immobile factor labour is carrying some of the burden from competition.

since the burden of high tax rates could be avoided, affecting the mobility of "real" capital or "real" profits as opposed to book profits.⁴⁰

3.2.3. Profit Shifting

Profit shifting is by its very nature difficult to measure. Estimates are subject to large uncertainty and should be interpreted with caution.⁴¹ The presence of affiliates in low-tax countries by multinationals and the relatively lower tax rates based on accounting figures for these affiliates may at best signal the possible existence of an issue, but they cannot be used to infer the extent of the problem. Several reasons other than taxation can induce a multinational to have a presence in some low-tax countries. Effective tax rates based on accounting figures have received considerable attention in the media over the last years with the emergence of the financial crisis. Very low effective tax rates on foreign profits were reported for well-known corporations, especially of the digital economy, and were often compared with the effective tax rate on domestic income⁴². However, conceptually the comparison of the effective tax rates on foreign profits should be made with the unobservable effective tax rate on foreign profits in the absence of profit shifting, rather than with the actual effective tax rate on domestic income. More generally, these effective tax rates vary for several reasons and depend for instance on the investment policy of a company – with the related depreciation provisions - and tax loss carry forward.⁴³ Other concerns can be raised for those tax avoidance aggregate measures based on the computation of "tax gaps" that do not distinguish between international and domestic tax avoidance and for those measures that compute "theoretical" tax liabilities without recognizing all those tax provisions entailing a reduction of taxation such as R&D incentives and again capital allowances.

More robust evidence of profit shifting has to be necessarily indirect and builds on different empirical estimation strategies, such as comparing pre-tax profits of low and high-tax affiliates, tracing the effects of an increase of profits in high-tax countries' affiliates on the profits of low-tax countries' affiliates, and comparing in a proper way the tax payments of multinationals and domestic companies. In the following paragraphs the results of the different empirical approaches are presented.

Indirect evidence of profit shifting can be obtained by comparing the pre-tax profitability of high- and low-tax affiliates and studies suggest that an increase of the

⁴⁰ See for instance Overesch (2009).

⁴¹ For a recent survey see Riedel (2014). This section mainly draws on her paper. For another review of the literature see also Dharmapala (2014). See also OECD (2013a). In the context of the OECD BEPS Action Plan (Action 11), work has been carried out on indicators of scale and economic impact of BEPS (OECD, 2013b).

⁴² The final report of the Expert Group on Taxation of the Digital Economy reports effective tax rates based on accounting figures for the largest corporations of the digital economy and for the major non-digital companies by market capitalization. Overall, it emerges that these effective tax rates are lower for non-US income and that this pattern is more pronounced for the digital companies. For instance, for Google (Apple) the effective tax rates on foreign profits are equal to 3.2% (2.5%), 5.3% (1.9%) and 8.6% (3.7%) for 2011, 2012 and 2013 respectively; the effective tax rates on US income are instead equal to 49.9% (75.3%), 40.8% (70.2%) and 26.4% (61%) for the same years (see Expert Group on Taxation of the Digital Economy, 2014, Report: 54-55).

⁴³ Yahoo is an example of the difficulties in the interpretation of the accounting figures as measures of effective taxation. Given some non-ordinary transactions in 2012 and 2013, the pattern found for the other digital economy companies (with the effective tax rates on foreign profits considerably lower than the rate on domestic profits) is for Yahoo completely reversed (see Expert Group on Taxation of the Digital Economy, 2014, Report, page 54).

host country CIT rate of ten percentage points would lower affiliates pre-tax profits in that country by 8%. Theory predicts that tax avoidance will typically entail a decrease of (pre-tax) profitability in the high tax country and a corresponding increase in the low tax country. In fact, econometric studies confirm the existence of such a negative correlation between corporate income tax and reported pre-tax profits. Heckemeyer and Overesch (2013) summarize the results of 238 estimates of the effects of corporate tax rates on reported profits found in 25 empirical papers. They obtain a consensus figure for the tax semi-elasticity equal to 0.8: An increase of the CIT rate of 10 percentage points (p.p.) lowers affiliates' pre-tax profits by 8%.

These estimates of the sensitivity of profits to corporate tax rate differentials can in principle be used to estimate the revenue losses due to profit shifting, but they have to be interpreted with caution. There could be reasons other than tax avoidance that generate a (positive or negative) correlation between pre-tax profits and corporate income taxation. For instance, a higher taxation in a country requires a higher pre-tax profitability in order to invest in that country, and this generates a positive correlation between pre-tax profits and corporate income taxation. As another example, a higher taxation in a country may determine a lower effort provision by affiliates' managers in that country because less earned income could be kept or "extracted" when taxation increases and this tends to generate a negative correlation between pre-tax profits and corporate income taxation.⁴⁴

Econometric evidence on profit shifting can also be derived identifying unexpected changes of profits in high-tax locations (shocks) and estimating how these are transmitted to low-tax countries' affiliates. This approach is used by Dharmapala and Riedel (2013) who estimate that about 2% of the additional profits arising in a high-tax country are transmitted to low-tax countries affiliates. The authors argue however that this is likely to be only a lower bound of the profit shifting for issues related to their dataset and their identification strategy.

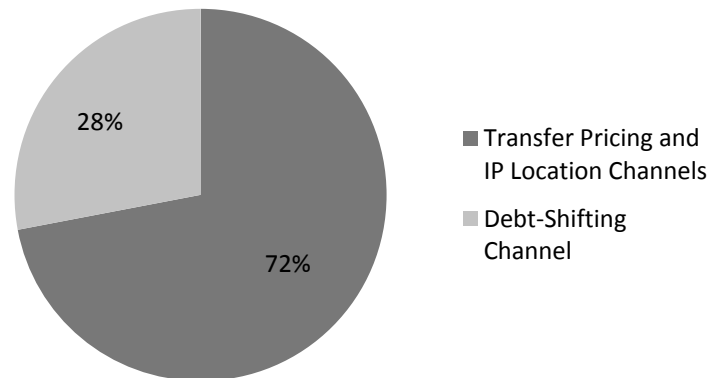
Another estimation technique used to measure the size of profit shifting is to compare the tax payments of multinational and similar domestic companies. Studies suggest that this difference is about 30%. Since these two categories of companies are different for several reasons, the comparison of the tax payments is made only for those companies that are identified through a statistical process of matching, and therefore that are "similar" from a statistical point of view. In this way, the different tax payment can be attributed to the different profit shifting possibilities related to the status of being a multinational or a domestic company. Egger et al. (2010) use this estimation strategy and find that multinationals in European high-tax countries pay about 32% less CIT than "matched" domestic companies. This estimate is of the same order of magnitude of the 27% found by Finke (2013) for Germany using the same econometric model. A word of caution is necessary however for these studies as well. There could be unobservable aspects explaining the difference between these two classes of companies and biasing therefore the results. For instance, to the extent that governments deliberately try to attract multinationals granting them specific tax benefits, the estimated gap would be partly attributable to factors other than tax avoidance.

A part of the empirical literature focuses on the importance of specific channels of profit shifting. Overall, pricing of intra-firm transactions and strategic IP location seem to explain about 70% of profit shifting. The policy relevance of this empirical literature is

⁴⁴ See Riedel (2014).

straightforward: by providing statistical information on the relative importance of the different tax avoidance channels, it is possible to design correctly the anti-avoidance measures to maximize their effectiveness, while at the same time minimizing the downside effects in terms of compliance and administrative costs. The pricing of intra-group transactions, the strategic location of IP, and the debt-shifting channel are all statistically important, although in relative terms the first two channels account for more than two thirds of the overall profit shifting activities (see graph 8).⁴⁵

Graph 8. The relative importance of the different profit shifting channels



Source: Commission Services

a. Profit shifting via transfer pricing

Empirical analyses of tax-motivated transfer pricing show a significant impact of corporate taxation on internal import and export prices. The empirical evidence is available for the US and some European countries. According to the estimates by Davies *et al.* (2014) for France, large multinationals and some tax havens play a crucial role in these profit shifting activities. For European multinationals, Lohse and Riedel (2013) find robust evidence of profit shifting. They also find that transfer pricing documentation and special transfer pricing penalties are very effective in tackling the issue. Table 2 gives an overview of the most important studies on the impact of transfer price manipulation and their results.

⁴⁵ See Heckemeyer and Overesch (2013).

Table 2: Overview of studies analysing transfer price manipulation

Transfer pricing studies			
Clausing (2003)	US (1997-1999)	Export prices	-1 percentage point of CIT rate in the destination country reduces export prices by 1.8%
Bernard et al. (2006)	US (1993-2000)	Wedge between arm's length and intra-firm prices	- 1 percentage point of CIT rate increases the wedge by between 1.6 and 4.2%
Cristea and Nguyen (2013)	Denmark (1999-2006)	Export prices	Owning an affiliate in a low-tax country reduces export prices by between 5.7% and 9.1%.
Davies et al. (2014)	France (1999)	Wedge between arm's length and intra-firm prices	For exports in tax havens, intra-firm prices are estimated to be 11% lower than arm's length prices. + 10 p.p. of CIT rate decreases reported pre-tax profits by 3.94%. Transfer pricing documentation and special transfer pricing penalties reduce profit shifting by around 50%.
Lohse and Riedel (2013)	Europe (1999-2009)	Earnings Before Interest and Taxes	+ 10 p.p. tax rate differential between France and its trade partners reduces intra-firm export prices by 2.2% and increases intra-firm import prices by 2.4%.
Vicard (2014)	France (2000-2012)	Intra-firm export and import prices	

Source: Commission Services

b. Profit shifting via the location of Intellectual Property

Recent econometric evidence shows the importance of profit shifting through the strategic location of Intellectual Property (IP). The corporate tax seems to affect IP in the balance sheets, the patent applications, as well as the sensitivity of pre-tax profits to changes of the CIT rate. As regards the location of IP, for instance, Karkinski and Riedel (2012) find that an increase of 1 percentage point of the corporate tax rate reduces the number of patent holdings by about 3.5%. The estimates in Böhm et al. (2012) for Europe indicate that the probability of patent relocation to a tax haven is increasing with the value of the patent and that controlled foreign company (CFC) - legislation may be effective in reducing this form of profit shifting. Beer and Loeprick (2014) find that mandatory documentation requirements are effective in reducing profit shifting by transfer pricing; this result does not hold for those subsidiaries with large intangible assets. Table 3 summarizes the findings of recent studies on the use of intangibles for profits shifting purposes.

Table 3: Overview of studies analysing intellectual property location

Intangible assets			
Dischinger and Riedel (2011)	Europe (1995-2005)	Intangible property in the balance sheets	- 1 p.p. in the average tax difference to all other group affiliates increases the subsidiary's IP in the balance sheet by about 1.7%
Karkinski and Riedel (2012)	Europe (1978-2007)	Patent holdings	+1 p.p. of CIT rate decreases patent applications by about 3.5%-3.8% (depending on the empirical model)
Griffith et al. (2014)	Europe (1985-2005)	Patent holdings	+1 p.p. of CIT rate decreases patent applications by about 0.5%-3.9% (depending on the location)
Beer and Loprick (2014)	World (ORBIS) (2003-2011)	Tax sensitivity of reported profits and endowment of intangible assets	Tax sensitivity of reported profits to 1 p.p. increase of the CIT rate increases from 0.76% to 1.2% for subsidiaries with an above median intangible assets endowment.
Böhm et al. (2012)	Europe (1978-2007)	Probability of patent relocation to tax haven and effectiveness of CFC legislation	An increase of 1 standard deviation of patent value increases the probability of patent relocation in a tax haven by about 16%. This probability of patent relocation in a tax haven is reduced by about 1/3 by CFC legislation.
Joint Research Centre - TAXUD (2015)	World (2000-2011) top 2,000 corporate R&D investors	Patent holdings	+ 1 p.p. of CIT rate decreases patent applications by about 13.1% (pharmaceutical), 1.5% (ICT sector) and 5.4% (car sector). The presence of patent boxes has a strong and significant effect on patent applications.

Source: Commission Services

c. Profit shifting via intra-firm debt

Multinational companies also shift profits by locating equity in low tax countries while financing subsidiaries in high tax countries with intra-firm debt to benefit from the deductibility of interest from the tax base. The most recent evidence for Europe shows that foreign-owned plants have a higher debt-asset ratio than domestically owned plants. This gap increases with the CIT rate of the host country as shown by Egger et al. (2010). For German multinationals, Schindler et al. (2013) find that in a group with two affiliates, a 10 p.p. increase of the CIT rate in the high-tax country increases the debt-asset ratio by 4.6% in that country and lowers it by 1.4% in the other country. 40% of the increases of the debt asset ratio are due external debt, the rest to internal debt according to this study. Riedel (2014) finds that the tax elasticities in the literature imply that on average an increase of 10 percentage points of the CIT rate is associated with an increase of about 10% of the affiliated internal debt-ratio. Table 4 gives an overview of empirical studies analysing the debt-shifting channel.

In conclusion, there is clear evidence of profit shifting activities by multinational companies. The most important channels are transfer pricing manipulations and the use of intangible asset location. Debt shifting is a third channel but less important compared to the other two. From a policy perspective this means that solutions to tackle the profit shifting problem should concentrate in improving the consistency of transfer pricing and by reducing incentives to shift income related to intangible assets.

Table 4: Overview of studies analysing intra-firm debt shifting

Debt-Shifting Channel			
Desai et al. (2004)	US (1982-1994)	Debt/Asset (internal and external)	+10 p.p of CIT rate increases the affiliates' debt/asset ratio by about 2.8% (about 1.9% for external debt and 3.5% for internal debt). For a multinational with two affiliates, a 10 p.p. increase of the CIT rate in one country increases the debt/asset ratio by 2.4% in that country and lowers it by 0.6% in the other country.
Huizinga et al. (2008)	Europe (1994-2003)	Debt/Asset	Foreign-owned plants exhibit a debt/asset ratio higher than domestically owned plants by 1.7 p.p. This gap increases with the CIT rate of the host country. + 1 p.p. of CIT rate in the host country is associated with an increase of the debt/asset ratio by 0.7 p.p.
Egger et al. (2010)	Europe (1996-2004)	Debt/Asset Ratio of domestically and foreign-owned plants	+10 p.p. of tax rate difference with respect to the lowest-tax affiliate increases internal debt ratio by about 0.73%.
Büttner and Wamser (2013)	Germany (1996-2005)	Internal Debt Ratio	For a multinational with two affiliates, a 10 p.p. increase of the CIT rate in the high-tax country increases the debt/asset ratio by 4.6% in that country and lowers it by 1.4% in the other country. 40% of the increases of the debt asset ratio are due external debt, the rest to internal debt.
Schindler et al. (2013)	Germany (1996-2006)	Internal and External debt/asset ratio	

Source: Commission Services

4. OPTIONS

The interplay of the current distribution of taxable profits, higher capital mobility due to globalization and digitalisation and the lack of a similar international integration of tax policies can lead to tax competition and profit shifting. The question is how the three main roots of the problem (1) distribution of taxable profits, (2) increased capital mobility and (3) insufficient co-ordination of tax policies at the international level can be addressed to reach the objective to tax profits there where the economic activity takes place. Three areas of action can be identified and are described in more detail in the action plan accompanying the Communication and this Staff Working Document:

- 1. The first action area would seek to replace the current system of distributing taxable profits and create a more stable allocation rule.** The most obvious candidate for this is the CCCTB. In economic tax research also the possibility of new systems such as destination based cash-flow taxes are discussed.
- 2. The second set of actions comprises measures which try to reform the current international tax rules by closing loopholes and fixing issues in the current system of separate accounting, arm's length pricing and bilateral tax agreements.** In this area measures related to BEPS are covered as well as actions to improve transfer pricing and the income flows related to intangible assets. The discussion about an effective level of taxation would also fall in this category. The reason is that effective tax levels would not generally change the distribution of taxable profits among countries but - depending on the base chosen – they would rather impact the current revenue allocation for specific income types.

3. **The last area is to improve the current way of working together at the EU level on tax issues by reforming the governance structure and improve the overall exchange of information.** This would not only increase the overall transparency of tax discussions at the EU level and reduce possible information asymmetries between tax administrations. A stronger overall information exchange on capital income (at the corporate but also at the private level) could act as a break or even reduce the impact of capital mobility.

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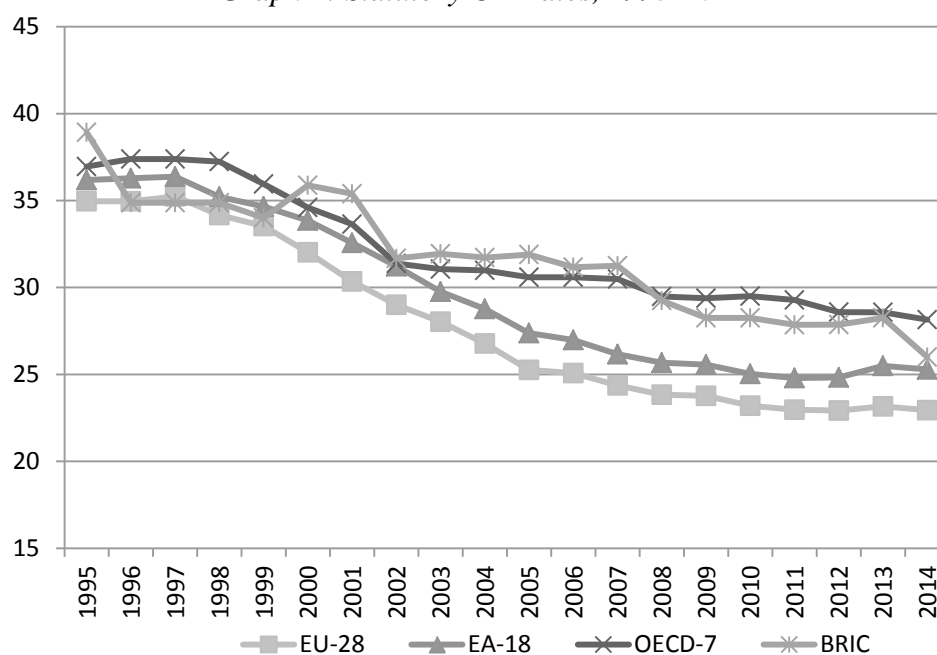
ANNEX 1 STYLIZED FACTS ABOUT THE CIT IN THE EUROPEAN UNION 1995-2015

A1.1 INTRODUCTION

This annex describes the evolution of the Corporate Income Tax in the 28 current Member States of the European Union. It relates this evolution to earlier descriptions in the economic literature. The evolution of statutory corporate income taxes since the 1980's has been described in many studies⁴⁶. Devereux, Griffiths and Klemm identified in their 2002 paper a number of stylized facts. These were updated in 2004 by Devereux and Sorensen. Their database ends in 2004 and describes some non-EU countries, but does not describe all current EU Members. This annex focuses on the EU over the period 1995-2014. It partly describes the same indicators as the aforementioned studies.

A1.2 THE EVOLUTION OF THE STATUTORY RATE IN THE EU COMPARED TO OTHER COUNTRIES.

Graph 1: Statutory CIT rates, 1995-2014



Source: Taxation Trends in the European Union (2014)

The worldwide reduction of statutory corporate income tax rates since the 1980s has continued at least until 2007. After that year, the pace of reduction in Europe levelled off. Devereux and Sorensen established that 'statutory tax rates have fallen substantially since the early 1980s; while the pace of reductions has varied over time, it appears to be continuing (in 2004)'. Graph 1 shows that this decline has continued in the period 1995-2014, notably up to 2007. In the EU, the reduction of the average CIT rate was stronger than in the other regions under consideration. These are the OECD-7 (Australia, Canada, Japan, Switzerland, Iceland, Norway and the USA) and the BRIC-countries (Brazil, Russia, India, and China).

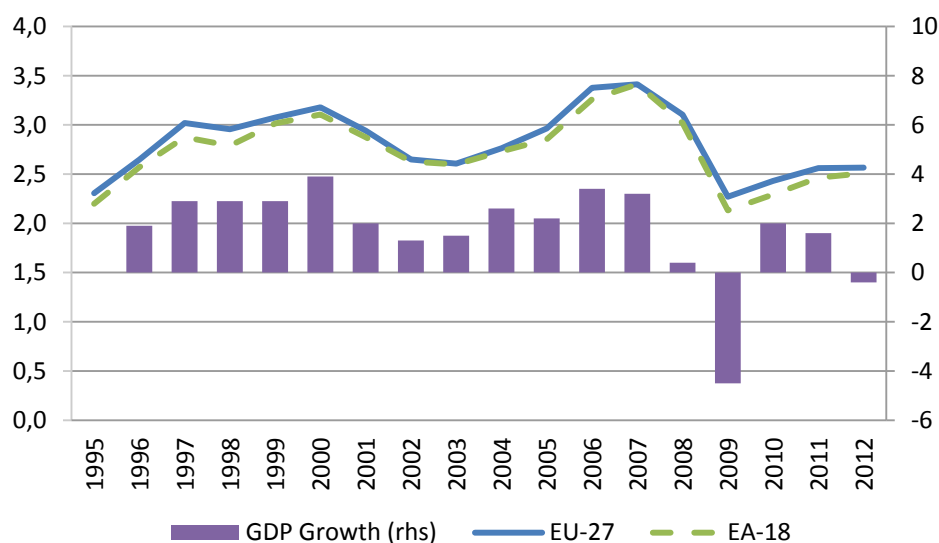
⁴⁶ For an overview, see Devereux and Loretz (2012).

The fact that rates have decreased more in Europe than in the other regions contributes to the image⁴⁷ that the EU is the driving force of the competition behind these reductions. The difference between the EU and notably the OECD-7 grew mainly in the period 2000 – 2005. In that period, the decline in the OECD-7 and the BRIC-countries subsided, while the decrease in the EU continued. After the crisis, the pace of the reductions in the EU receded, while Canada and Japan introduced new reductions. The USA was one of the few countries that did not change its rate over the considered period.

A1.3 THE EVOLUTION OF CORPORATE INCOME TAX REVENUES

The revenues of the Corporate Income Tax (CIT) show a volatile trajectory around 3 per cent of GDP and 8.5% of total tax revenues. Despite the reductions of the rates, the structural level seems to be relatively stable. Over the years, the development of the share of CIT can be divided into five stages. The averages show a strong increase in the period 1995 – 2000, a moderate reduction in the period 2000 – 2003, a strong increase in the run-up to the crisis in the period 2003 – 2007 and a steep decline during 2007-2009. After this decline the share of CIT more or less stabilised at a level close to that of 1995. This indicates that the share of CIT revenues is more or less stable. The volatility of CIT revenues is strongly related to fluctuations of economic growth. Not only are profits very responsive to economic growth, also the carry back of losses to earlier years can increase the reduction of CIT revenues during periods of lower economic growth.

Graph 2: Average share of CIT revenues to GDP, GDP growth, EU-27, 1995-2012



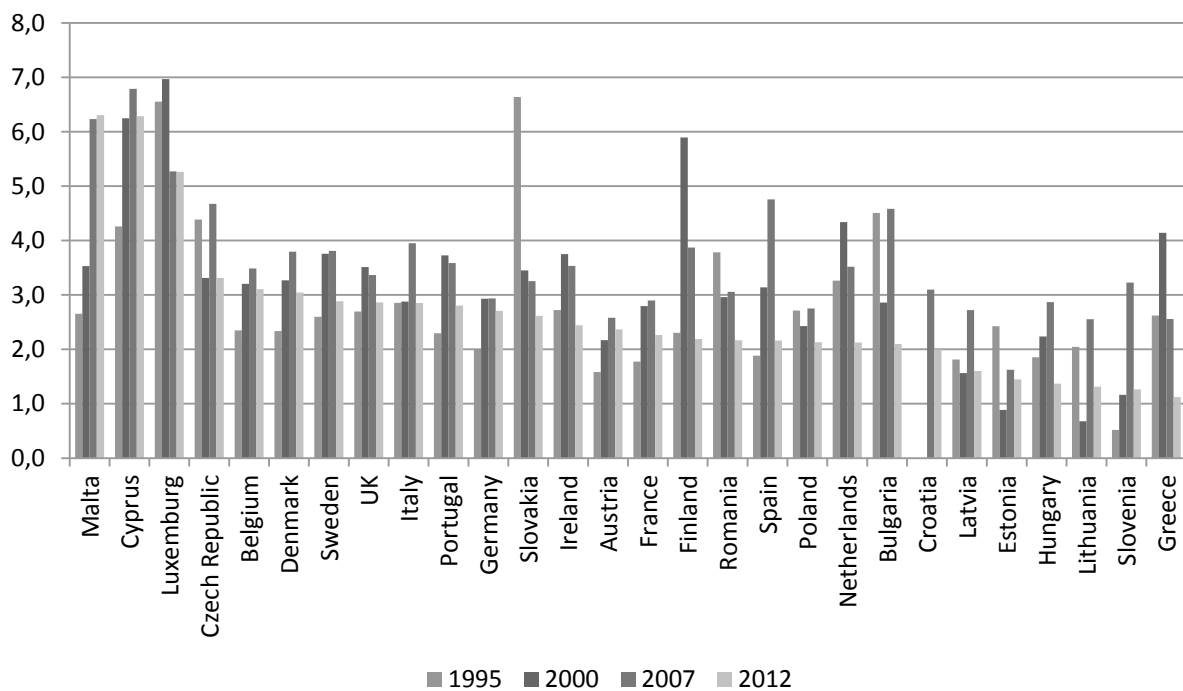
Source: Taxation Trends in the European Union (2014), Eurostat

In 2014, the share of CIT revenues to GDP is highest in Luxemburg (5.3 % GDP), Cyprus and Malta (both 6.3 % of GDP), while Greece, Slovenia and Lithuania receive 1.3 % or less of GDP from corporate income tax. Malta and Cyprus show the highest increase of the revenue share. Slovakia, Bulgaria and Romania experienced a considerable decline over the considered period. This is shown in graph 3, which ranks the

⁴⁷ In their study Devereux and Loretz state that 'most of the newer contributions (to the tax competition debate) see the European Union as driving force of tax competition'. (p.20).

Member State in descending order of their CIT to GDP rate in 2012. In 1995 this order looked different. Slovakia had the highest share of Corporate Income Tax to GDP (6.6 %), followed by Luxemburg, Bulgaria, Czech Republic and Cyprus. Austria and Slovenia (0.5 % of GDP) displayed the lowest share. Although the average share increased in the following period, many New Member States watched the share of corporate income tax decline. In 2000, Luxemburg (7.0 %) and Cyprus (6.2 %) had the highest share and the Baltic States (between 0.7 % and 1.6 %) and Slovenia (1.2 %) the lowest. In 2007, as the shares of corporate revenues were at an all-time high, Luxemburg (5.3 %), Cyprus (6.8 %) and Malta (6.2 %) had the highest shares and Estonia⁴⁸ (1.6 %), Lithuania (2.6 %) and Greece (2.6 %) the lowest. This has not changed much after the crisis: the same three countries have the highest shares while Slovenia, Greece and Lithuania are on the lower end of the ranking.

Graph 3: CIT revenues to GDP, EU-Member States, 1995, 2000, 2007, 2012



Source: Taxation Trends in the European Union (2014)

A1.4 A CLOSER LOOK ON THE DEVELOPMENTS IN THE EU.

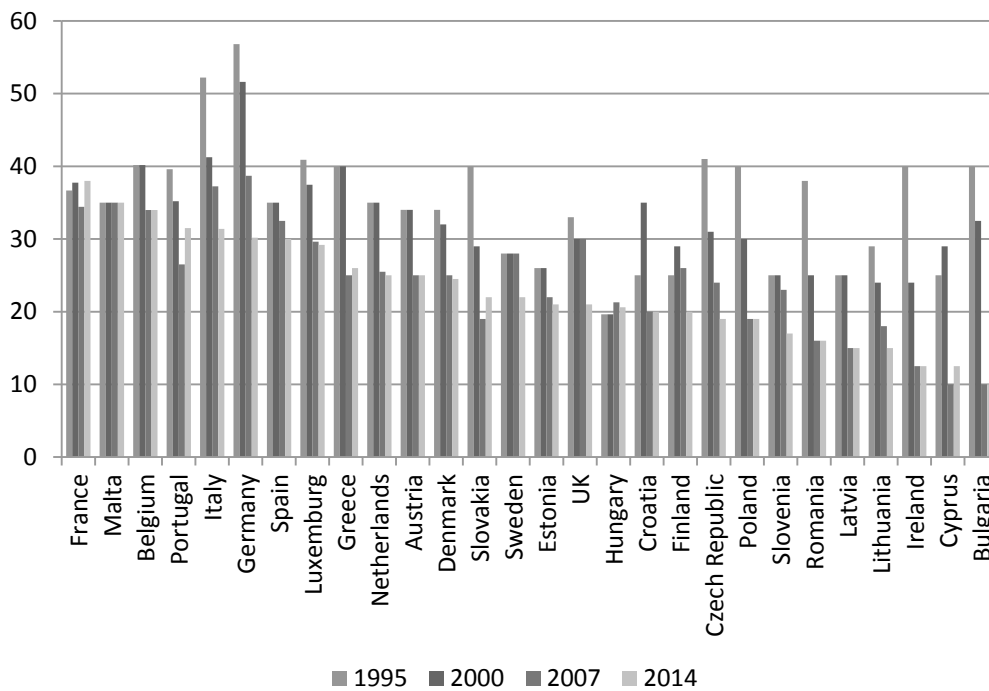
The reduction of the average rate was accompanied by a decrease of both the lowest and the highest rate in the EU. Graph 4 plots the statutory rates across the EU in 1995, 2000, 2007 and 2015. Member states are ranked by their statutory CIT rate in 2014. Graph 5 shows, apart from the EU-28 average, the evolution of the highest and the lowest statutory rates that were observed in the current EU, as well as those of the averages for other subgroups of the EU. Over the period 1995-2014, the EU-28 average rate declined by 12 percentage points from 35 % to 23 %. The highest rate was reduced from 56.8%⁴⁹ in Germany in 1995 to 38.0 % in France in 2014. The lowest headline rate, 19.6 % in Hungary in 1995, decreased to 10 %

⁴⁸ In 2000, Estonia limited the Corporate Income Tax to distributed profits.

⁴⁹ Including the local trade tax.

in Bulgaria in 2014. Germany held the highest rate until the corporate tax reform of 2001, in which year the German rate undercut the Italian one, which was at 40.3%. After a reduction in Italy in 2003, the German rate again was highest until the reform of 2008. In that year, statutory rates in all other Member States had been lowered below the Maltese level of 35 %. Only in 2012 the increase of the surcharge in France took the combined rate above the Maltese level⁵⁰. For the period 1995 – 2001 the lowest corporate tax rate, national rate plus local taxes, was to be found in Hungary at a level of 19.6%. In 2002 Lithuania reduced its rate to 15%, which was the lowest in that year. One year later, Ireland⁵¹ reduced the headline rate to 12.5 %, which became the lowest. Since 2005 the lowest rate available is 10%. This rate was available in Cyprus (2005-2012) and is in force in Bulgaria since 2006. All in all, the maximum rate was reduced by 18.8 percentage points and the minimum rate by 9.6%.

Graph 4: Statutory CIT rates, EU-Member States, 1995, 2000, 2007, 2014

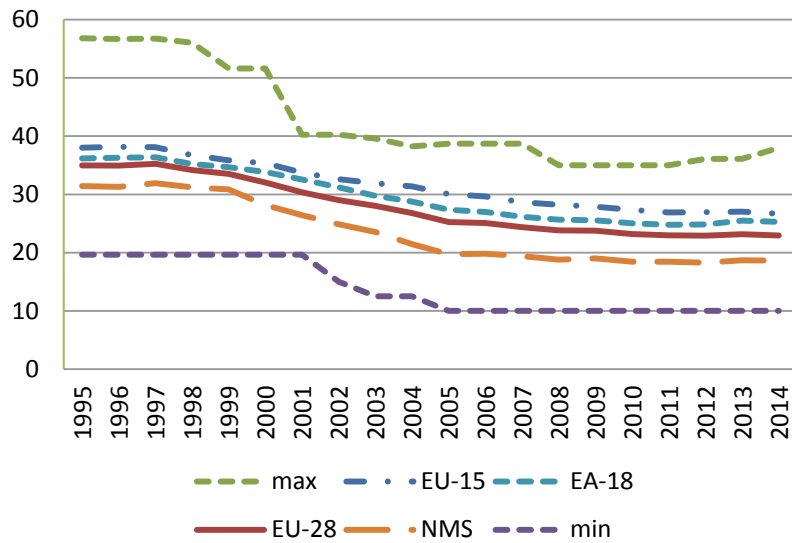


Source: Taxation Trends in the European Union (2014)

⁵⁰ Please note that the highest rate in France only applies to enterprises with a turnover of more than EUR 250 million and that the Maltese system of imputation and refunds is not taken into account.

⁵¹ Until 2003, Ireland applied a 10 % CIT rate to qualifying manufacturing and services companies.

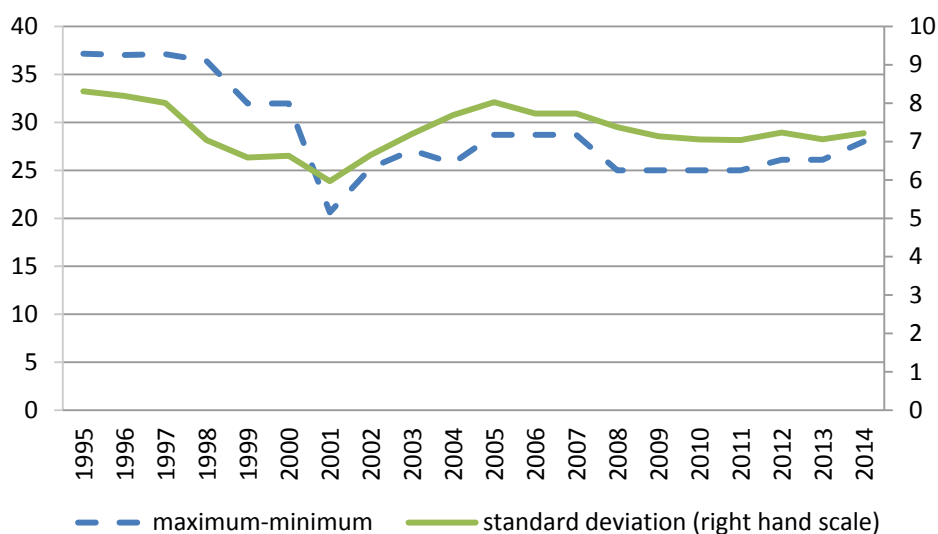
Graph 5: Statutory CIT rates, maximum EU-28, unweighted averages EU-28, EA-18, EU-15 and NMS, minimum EU-28, 1995-2014



Source: Taxation Trends in the European Union (2014)

Headline rates of different Member States have come closer to each other. In the period 1995 – 2001 the spread, the difference between the highest and the lowest corporate tax rate was reduced from 37 percentage points to 20 percentage points, mainly by the reductions in Germany. In later years reductions of the lowest rates increased the spread between minimum and maximum again. In the years 2007 – 2011 it stabilised at 25 percentage points. After that year, due to the increases in France, it rose again to 28 percentage points. This is plotted in graph 4. This graph also contains the standard deviation of the rates. This measure for the spread is less sensitive to the behaviour of the highest and the lowest rate. Its trajectory corroborates the image that the spread has been reduced until 2001, but rebounded to a level below that of 1995.

Graph 4: Measures of the spread of CIT-rates, EU-28



Source: Taxation Trends in the European Union (2014) and Commission services

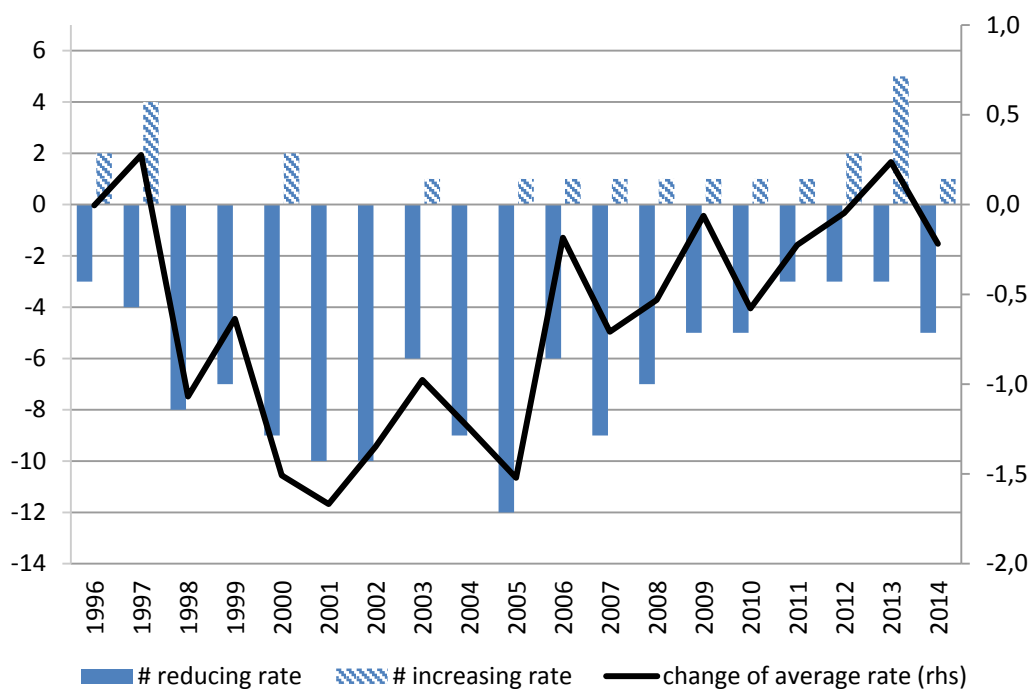
The reduction of the average corporate income tax rate in the period 1995-2014 was supported by almost all Member States. The fastest reduction took place in the period 2000-2005, when 23 countries reduced their rates. In the period 2005-2010, the number of Member States reducing the rate decreased, to decrease even further after the crisis. This is one of the causes of the levelling off of the reduction of the average rate. This is shown in table 1 and graph 5. Only in two Member States (France and Hungary), the rate was higher in 2014 than in 1995. In Malta, the rate didn't change over the period under consideration. Looking at five year periods, we see that in the period 2000-2005 both the number of countries reducing the rate and the average reduction were high. Only the UK, Sweden, Slovenia, Malta and Spain did not change the rate in that period. After the crisis still six Member States reduced the rate (the UK, Sweden, Finland, Slovenia, Netherlands and Denmark), but that was balanced by the same number of countries increasing the rate (Greece, France, Cyprus, Luxembourg, Portugal and Slovakia).⁵²

Table 1: Number of Member States increasing and decreasing the statutory CIT rate

	1995-2000	2000-2005	2005-2010	2010-2014	Total 1995-2014
Number reducing the rate	13	23	14	6	25
Number increasing the rate	4	0	2	6	2
Change of (unweighted) average rate	-2.9	-6.8	-2.1	-0.3	-12.0

Source: Commission services

Graph 5: Change of average CIT-rate and number of Member States increasing or decreasing rates



⁵² E.g. Chatelin and Peyrat: Are small countries leaders of the European tax competition?, Documents de travail du Centre d'Economie de la Sorbonne 2008.58

Source: Commission Services

Reductions in the new member states were larger and started earlier than in the old member states. In the literature on this subject, it is stipulated that tax competition is related to the openness of individual economies and the integration of the different economies. In this respect, the enlargement of the EU in 2004 could have caused an increase of the tax competition as the economies of the existing EU-15 states and the New Member States have become more open to each other and more integrated. We have already seen in graph 5 that the strongest reductions of CIT rates took place before the enlargement. In table 2 the evolution of the average CIT rate has been decomposed between the 'old' EU-15 and the New Member States. Overall, the New Member States reduced their rates stronger than the EU-15. They also started earlier. In the period 2000-2005 the reduction in the NMS was larger than that in the EU-15. In 2005-2010 the reductions in the EU-15 were larger than in the new member states.

Table 2: Change of (unweighted) average statutory CIT rate, 1995-2014

	1995-2000	2000-2005	2005-2010	2010-2014	Total 1995-2014
EU-15	-2.7	-5.3	-2.7	-0.6	-11.3
NMS	-3.3	-8.4	-1.3	0.2	-12.8
EU-28	-2.9	-6.8	-2.1	-0.3	-12.0

Source: Taxation Trends in the European Union (2014)

A1.5. BASE BROADENING: CHANGES IN CAPITAL ALLOWANCES

Base broadening has been less ubiquitous than rate reduction: Thirteen Member States have broadened the corporate tax base by reducing depreciation allowances, seven narrowed the base by increasing them and one reduced allowances for one type of investments and increased them for the other two types. The number of Member States increasing allowances for investments in intangibles exceeds the number reducing these allowances. Countries reducing the statutory Corporate Income Tax rate sometimes increase the tax base to partly compensate the revenues foregone. Devereux et al. use the development of depreciation allowances for machinery as an indicator for the broadening or narrowing of the corporate tax base. For the EU data on these allowances can be found in the yearly ZEW publication⁵³ on effective tax corporate tax levels. Table 3 shows the number of Member State changing depreciation allowance rules and the average change of the depreciation allowance⁵⁴. A reduction of the allowance means a broadening of the tax base. Reduction of the depreciation allowance has been used by roughly half of the Member States: thirteen Member States reduced the allowance for at least one type of investment: Denmark, Germany, Ireland, Greece, Spain, France, Italy, Malta, Austria, Poland, Romania, Slovenia and the UK. On the other hand, seven Member States increased the generosity of the allowance regime: Bulgaria, Czech Republic, Croatia, Cyprus, Lithuania, Hungary, Slovakia and Finland. Hungary allowed more depreciation of machinery and intangibles, but reduced depreciation of buildings. Estonia limited the corporate income tax to distributed profits in 2000. Until 2010, the number of Member States increasing allowances roughly balanced the number of Member States decreasing them. After 2010, base broadening became more popular. The desire of

⁵³ ZEW (2014): Effective Tax Levels Using the Devereux/Griffiths Methodology, Final Report 2014, Project for the EU Commission TAXUD/ 2013/ CC/120.

⁵⁴ The value of the allowances is calculated as the Net Present Value of the allowed depreciation for tax purposes.

administrations to attract investments in intangibles is reflected by the fact that more Member States increased allowances for this type of investment.

Some Member States used accelerated depreciation to try to increase investments after the crisis. Germany, the Netherlands, Austria and Finland introduced accelerated depreciation for machinery in 2009 to counter the reduction of investments in the crisis. After two or three years these measures were withdrawn.

Base broadening is more common in large economies than in smaller ones. Reduction of allowances is the strongest for buildings, less strong for machinery and the weakest for intangibles. On average, the depreciation allowances for buildings have been reduced, indicating base broadening.. The trend for the other types of capital depends on the way the average is being calculated. For machinery, the unweighted average of the allowance has remained almost stable, and the weighted⁵⁵ average has declined. The unweighted average allowance for intangibles even increased, while the weighted average has declined. All this indicates that base broadening has been stronger in countries with a higher GDP than in countries with a lower one.

Table 3: Number of Member States changing capital allowances and the change of the allowances

	1998- 2000	2000- 2005	2005- 2010	2010- 2014	Total 1998-2014
Industrial buildings					
<i>Number reducing the allowance (base broadening)</i>	2	4	4	3	10
<i>Number increasing the allowance (base narrowing)</i>	2	3	1	2	5
Change of unweighted average allowance	0.7	-2.0	-1.6	-0.1	-3.0
Change of weighted average allowance	-4.0	-2.0	-4.4	-1.9	-12.3
Machinery					
<i>Number reducing the allowance (base broadening)</i>	1	7	4	6	11
<i>Number increasing the allowance (base narrowing)</i>	1	5	4	2	7
Change of unweighted average allowance	0.2	1.6	0.4	-1.8	0.4
Change of weighted average allowance	-0.1	-1.4	-0.7	-3.5	-5.7
Intangible assets					
<i>Number reducing the allowance (base broadening)</i>	0	2	0	1	3
<i>Number increasing the allowance (base narrowing)</i>	3	4	0	1	6
Change of unweighted average allowance	1.8	1.0	0.0	0.6	3.4
Change of weighted average allowance	0.0	-2.1	0.4	-0.4	-2.0
One of the above					
<i>Number reducing allowances (base broadening)</i>	3	8	5	6	13
<i>Number increasing allowances (base narrowing)</i>	3	7	4	2	7

⁵⁵ GDP-weighted.

*Number increasing allowances for one type and
reducing for other types*

0 1 0 0 1

Source: Commission services, based on ZEW

A1.6 THE EVOLUTION OF EFFECTIVE TAX RATES

Due to the reduction of the statutory rate, the effective average tax rate and the effective marginal tax rate fell, but to a lesser extent than the statutory rates. Looking at the taxation of return on investments, the statutory rate and depreciation allowances are not the only determinants of the amount of payable tax. For instance, the way in which investment is financed - by retained earnings, new equity or debt – can influence the amount of payable tax. To grasp some of these differences, measures for the effective average tax rate (EATR) and the effective marginal tax rate (EMTR) have been constructed. The EATR is the share of taxes to be paid in the return on an investment with a *return* exceeding the cost of capital. The EMTR signifies the share of taxes on the marginal investment, which generates no net return over the cost of capital. Data for these two indicators for all EU Member States and a number of other countries are published yearly by ZEW.

In the literature it is assessed that the statutory rate mainly influences profit shifting, while discrete investment decisions depend on the effective average tax rate and capital flows depend on the effective marginal tax rate. In 1998⁵⁶, the average EATR was 5.1 percentage points lower than the average *statutory* rate (29.1 % and 34.2 %, respectively) and the EMTR 13.5 % (at a rate of 20.7 %) In table 3 it is shown that as statutory rates declined, also the effective tax rates have been reduced, but to a lesser extent than the statutory rate. The difference between the statutory rate and the effective average rate has been reduced by 3.1 percentage points and the difference between the effective marginal tax rate and the statutory rate by 6.2 percentage points. Not in all Member States the difference between statutory and effective rates fell. In Belgium, Estonia, Hungary and Portugal, it increased and in Malta it did not change.

It is in the line of expectations that effective rates will fall when statutory rates do and that the absolute reduction will be less for the effective rates. It is, however, not immediately clear if the different trajectories are an indication of base broadening. The statutory rate is clearly part of the effective rates. As the indicators used are averaged across types of investment (buildings, machinery, intangibles) and ways of financing (retained earnings, new equity, debt), the evolution of the effective rates in absence of any change of the base is not clear-cut.

Table 3: Change of average CIT rate, effective average tax rate, effective marginal tax rate, 1998 – 2014 in percentage points, EU-28

	1998-2000	2000-2005	2005-2010	2010-2014	Total 1998-2014
CIT rate ⁵⁷	-2.0	-6.1	-2.1	-0.3	-10.4
EATR	-1.7	-4.3	-2.0	0.1	-8.0
EMTR	-1.9	-1.4	-2.5	0.8	-4.9

Source: ZEW and Commission services

A1.7 PREFERENTIAL REGIMES.

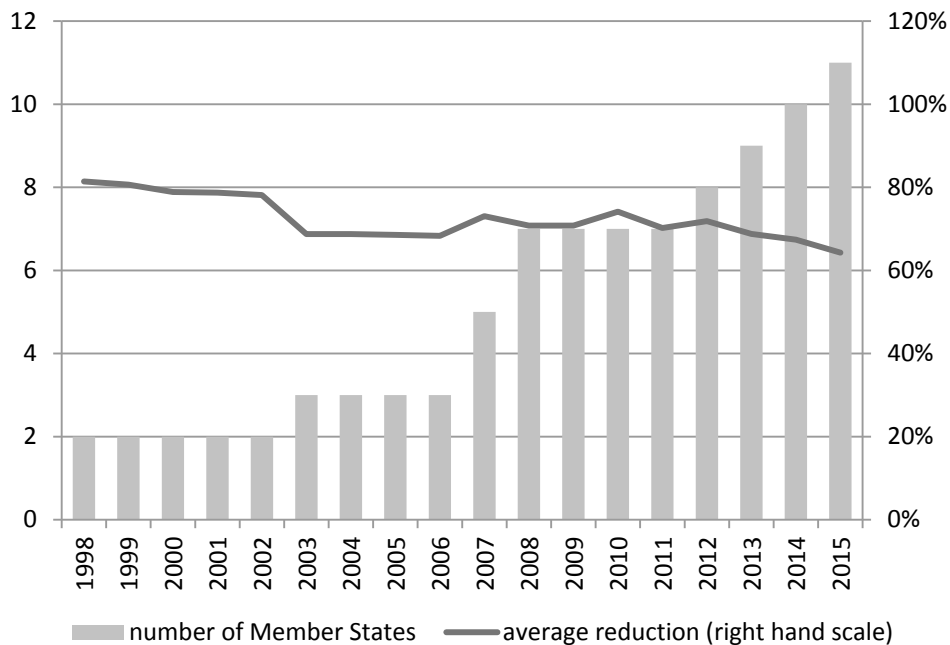
The number of Member States with an IP box started to increase in 2007. In 2014 ten Member States offer a special CIT rate for the proceeds of R&D. Apart from changing the tax rate and base, countries can compete by many other means. A common measure taken by

⁵⁶ 1998 is the first year of the ZEW publications

⁵⁷ To keep the table consistent, in this table CIT rate data from ZEW are being used. These differ slightly from those published in Taxation Trends in EU-Member States

Member States is the introduction of a preferential regime for profits originating from the development or the purchase of intellectual property (IP). Although modalities differ⁵⁸, the common feature is that profits derived from the use of intellectual property (IP) are being taxed at a reduced rate. This type of system existed in France and Ireland in 1998. Hungary introduced an IP-box in 2003 followed by Netherlands and Belgium in 2007 and by Luxemburg and Spain in 2008. Finally, Malta, Cyprus, the UK and Portugal took likewise measures in 2010, 2012, 2013 and 2014, respectively, while Ireland abolished its rule in 2010. The so-called IP box offers a rate with a reduction⁵⁹ with respect to the headline CIT rate. The lowest reduction is 50 % in Hungary and Portugal, while Malta offers a reduction of 100 %. The rise in the number of IP-boxes occurred when the reduction of corporate tax rates decelerated. It should be noted that these boxes are under scrutiny of the European Commission. In Graph 7 the number of countries involved and the average discount is reproduced.

Graph 6: Number of Member States offering IP boxes and average reduction of rates



Source: Commission Services

A1.8 THE RELATION BETWEEN GDP AND STATUTORY RATES

According to economic theory, larger countries are less vulnerable to tax competition than smaller countries. Several authors⁶⁰ point at a relation between size and tax competition. For large economies the necessity to compete for foreign investments would be less and the loss from rate reductions would be higher than in smaller countries. Therefore, rates in larger countries would be higher than in smaller countries. To shed some light on this hypothesis, graph 8 plots the level of the corporate tax rate against GDP in 1995.

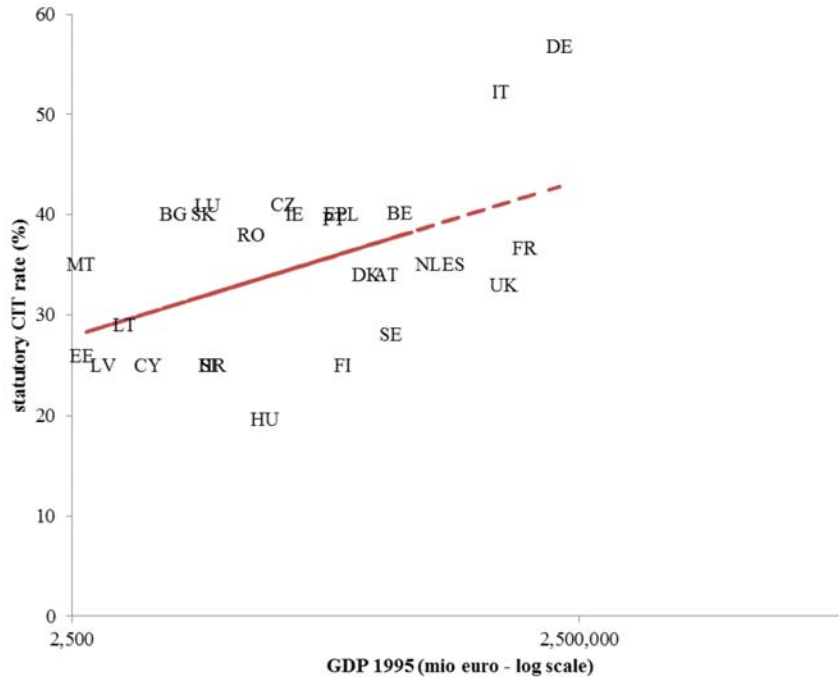
⁵⁸ Data based on the information in JRC/TAXUD (2015)

⁵⁹ For instance, the rate of the Dutch 'innovation box' is 5 %. Compared to the headline rate of 25 %, this is a reduction of 80%.

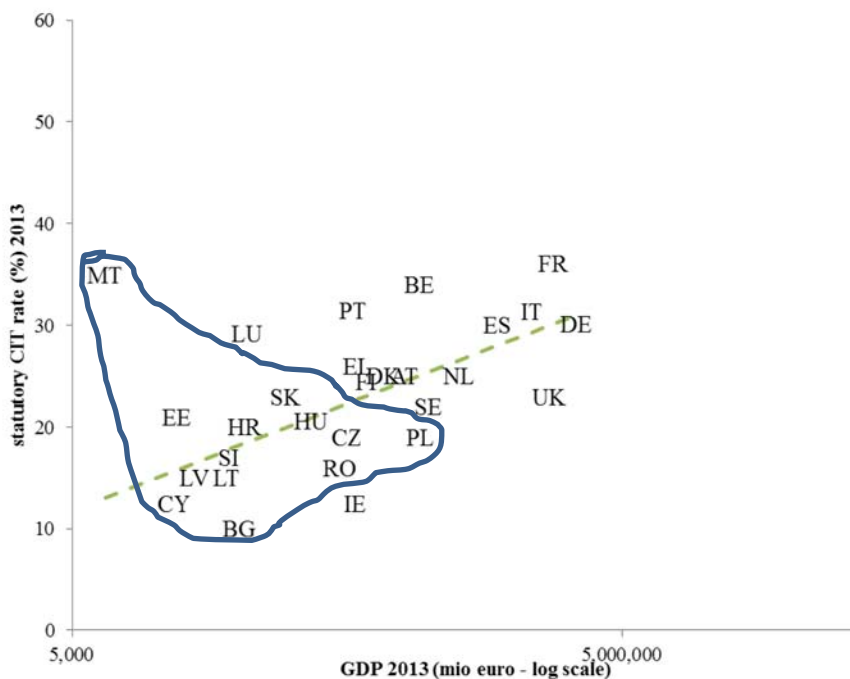
⁶⁰ E.g. Slemrod (2004) and Chatelais and Peyrat (2008)

In 1995 Germany and Italy dominate the image. Looking at the picture for 1995, the high rates in Italy and Germany immediately meet the eye. For the rest, the image is mixed. A number of (future) Member States with low GDP have high statutory corporate tax rates.

Graph 8: Relation of GDP and statutory CIT rate, 1995



Graph 9: Relation of GDP and statutory CIT rate, 2013



Source: Commission services

In 2013, smaller countries seem to have lower rates than larger countries. Especially the New Member States have decreased their ranking⁶¹. Graph 9 shows the situation for 2013. A line has been drawn around the New Member States. The 2013 situation shows another outlier. Malta, that did not change its rate, appears among the countries with the highest corporate rates. For the rest, New Member States that had relatively high rates in 1995 now are below the average (e.g. Czech Republic and Poland) or at the lower end (Bulgaria) of the distribution.

⁶¹ With the exception of Malta.

ANNEX 2 **APPLICATION OF THE COMMISSION RECOMMENDATION ON AGGRESSIVE TAX PLANNING AND ON MEASURES TO ENCOURAGE THIRD COUNTRIES TO APPLY MINIMUM STANDARDS OF GOOD GOVERNANCE IN TAX MATTERS**

The purpose this paper is to provide factual information relating to the application of the Recommendations on aggressive tax planning and on measures intended to encourage third countries to apply minimum standards of good governance in tax matters, which contributed to the Commission Action Plan in 2012⁶².

In response to the Recommendations, the Council invited Member States to consider the appropriateness of incorporating a General Anti Abuse Rule, such as that suggested in the Recommendation on aggressive tax planning, in their national legislation and invited consideration of whether developing a European list of third country non-cooperative jurisdictions is appropriate (ECOFIN conclusions of 14 May 2013 and European Council conclusions of 22 May 2013).

The application of the Recommendations has been discussed in the Platform for Tax good Governance, which is composed of representatives of the 28 Member States and of 15 organisations representing business, civil society and tax practitioners. One of the purposes of the Platform of good tax governance is to assist the Commission in preparing its report on the application of the Recommendations. This was one amongst the priorities in the agreed work programme of the Platform. Accordingly, the Platform held discussions on both Recommendations at its meetings on 16 October 2013, 6 February 2014, 10th June 2014, 19th December 2014 and 2nd March 2015.

The detailed work of the Platform and all related documents are available on the dedicated [webpage](#) of DG Taxation and Customs Union.

The purpose of the **Recommendation regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters** is to increase the overall effectiveness of the measures taken by each Member State in relation to third countries not meeting the minimum standards of good governance in tax matters (transparency, exchange of information, and fair tax competition). To this effect, the Recommendation provides criteria making it possible to identify third countries not meeting these minimum standards, and lists a series of actions that Member States may take in relation to such countries.

The work programme of the Platform for tax good governance provides that '*The Platform will discuss and suggest a mechanism or process to ensure consistency in the establishment and monitoring of the black lists. Where appropriate, the Platform can suggest follow-up or complementary steps to the current Recommendation, both regulatory and organisational, with a view to contributing to its essential goal: global promotion of the EU standards of good governance in tax matters*'.

⁶² An Action Plan to strengthen the fight against tax fraud and tax evasion (COM(2012)722), Recommendation regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters (C(2012) 8805) and Recommendation on aggressive tax planning (C(2012) 8806).

The purpose of the **Recommendation on Aggressive Tax Planning** is to better enable Member States to address aggressive tax planning by reducing double non-taxation and ensuring a minimum level of protection across the EU MS by the adoption of a general anti-abuse rule (GAAR) taking into account the limits imposed by Union law.

The work programme of the Platform provides that *'The Platform will discuss how a common interpretation of the GAAR recommended by the Commission can best be ensured. Where needed, the Platform will discuss how the application of the GAAR relates to tax incentives introduced by individual Member States.*

The Platform will discuss possible ways to implement a tax treaty clause which ensures that treaty provisions aimed at avoiding double taxation do not enable double non-taxation. It will also discuss best-practices that could assist Member States in the practical application of such clauses'.

The outcome of the work of the Platform so far is reflected in the discussion paper *Platform/13/2014/EN/rev2* (see annex 3). Based on factual elements, discussions held in the Platform, and conclusions discussed within the Platform, this paper reviews how the Recommendations have been followed-up by Member States and mentions some possible further steps.

PLATFORM FOR TAX GOOD GOVERNANCE

Discussion paper on the follow-up of the Commission Recommendations of 6 December 2012

Building blocks

Meeting of 2nd March 2015

Disclaimer:

This annex 3 is a Commission services working paper prepared by DG TAXUD for discussion purposes. It does not represent a formal Commission or Commission services position or policy. The paper is therefore without prejudice to any position which may be taken by the Commission in the future.

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1. INTRODUCTION

When adopting its Action plan and two Recommendations⁶³, the Commission committed to report within three years on the application of the Recommendations.

In response to the Recommendations, the Council invited Member States to consider the appropriateness of incorporating a General Anti Abuse Rule, such as that suggested in the Recommendation on aggressive tax planning, in their national legislation and invited consideration of whether developing a European list of third country non-cooperative jurisdictions is appropriate (ECOFIN conclusions of 14 May 2013 and European Council conclusions of 22 May 2013).

One of the purposes of the Platform of good tax governance is to assist the Commission in preparing its report⁶⁴ on the application of the Recommendations. This was one amongst the priorities in the agreed work programme of the Platform. Accordingly, the Platform held discussions on both Recommendations at its meetings on 16 October 2013, 6 February 2014, 10th June 2014 and 19th December 2014.

All Member States support tackling tax avoidance and tax evasion, but there are differences of opinion on how that can be achieved.

The present document aims at preparing the field for this Commission report on the application of the two Recommendations. The paper is structured around building blocks and contains some suggestions for the way forward. Members of the Platform are invited to provide comments at the meeting. Written comments are also welcome.

2. APPLICATION OF THE RECOMMENDATION REGARDING MEASURES INTENDED TO ENCOURAGE THIRD COUNTRIES TO APPLY MINIMUM STANDARDS OF GOOD GOVERNANCE IN TAX MATTERS

The purpose of the Recommendation is to increase the overall effectiveness of the measures taken by each Member State in relation to third countries not meeting the minimum standards of good governance in tax matters (transparency, exchange of information, and fair tax competition). To this effect, the Recommendation provides criteria making it possible to identify third countries not meeting these minimum standards, and lists a series of actions that Member States may take in relation to such countries.

The Commission services intend to report on the basis of:

- the factual elements contained in the discussion paper presented to the Platform for its meeting on 19 December (*Platform/11/2014/EN*),

⁶³ An Action Plan to strengthen the fight against tax fraud and tax evasion (COM(2012)722), Recommendation regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters (C(2012) 8805) and Recommendation on aggressive tax planning (C(2012) 8806).

⁶⁴ Formally, DG Taxation and Customs Union (TAXUD) will prepare a draft in consultation with other Commission services, for consideration by the College.

- the discussions held in the Platform,

- and to draw possible conclusions on how the Recommendations have been followed-up by MS. Such conclusions may in fact go further, and outline ways of making the content of the Recommendations more easy to apply.

This structure is the one followed under each section (criteria used, lists, etc.).

It should be noted that no Member State has so far reported having fully followed the Recommendation.

The Recommendation regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters ('tax havens' Recommendation) was discussed at the Platform meetings of 16 October 2013, 6 February 2014, 10 June 2014 and 19 December 2014. A questionnaire, to which all MS replied, was circulated to allow a comparison across Member States (MS) on criteria applied and measures triggered.

4.1 Criteria used

2.1.1. Factual elements

Information based on document Platform/11/2014/EN

Member States have reported using various types of criteria, sometimes in combination, for assessing the tax systems of other countries. However these criteria may be used for other purposes than establishing lists.

Criteria provided for by the Recommendation

- Compliance with transparency and exchange of information standards⁶⁵: this criterion is used by 18 MS (BE, BG, CY, CZ, DE, EE, EL, ES, FR, HR, IE, IT, LT, LV, PL, PT, SE, UK), out of which 13 MS use it for blacklisting purposes⁶⁶ only one MS (DE) uses it as sole criterion for blacklisting purposes, and one MS (UK) uses it for a different listing system.
- Absence of harmful tax measures⁶⁷: this criterion is used by 12 MS (BE, BG, CY, EE, EL, HR, IT, LT, LV, PL, PT, SE), but not all for blacklisting purposes. All 12 MS use the "absence of harmful tax measures" criterion in combination with the "transparency and exchange of information" criterion.

Additional or different criteria

- Tax level: 8 MS (BE, BG, EL, FI, LT, LV, PT, SI) report using the level of taxation for blacklisting purposes⁶⁸. Out of these 8 MS, 6 (BE, BG, EL, LT, LV, PT) combine it with the two criteria of the Recommendation, and 2 MS (FI and

⁶⁵ Type of criterion recommended in Commission Recommendation C(2012) 8805 point 3a

⁶⁶ Out of these, 3 MS have no list system (CY, CZ, IE), one use it for white list (SE) and one has another listing system (UK)

⁶⁷ Type of criterion recommended in Commission Recommendation C(2012) 8805 point 3b

⁶⁸ 4 other MS (AT, CY, HU, SE) refer to the level of taxation for other purposes than blacklisting.

SI) use the level of taxation as sole criterion. The tax rate/level threshold varies from 4%⁶⁹ (BG) to 15%⁷⁰ (FI); it is expressed either as a fixed percentage or by reference to the tax rate of the MS concerned.

- Other criteria: existence of a double tax convention, an exchange of information agreement or a convention on mutual assistance (13 MS: BG, EE, EL, ES, FI, FR, HR, HU, LV, PL, SI, SK, UK), non-EU or non-EEA countries (8 MS: BG, CZ, EL, FI, HU, LV, SI, SK), artificiality of transactions (RO), automatic exchange of information and least developed countries (UK). These criteria are used for blacklisting, whitelisting or for other purposes.

2.1.2. Discussions in the Platform

- **Transparency and exchange of information (TEOI).** Platform members agreed that the work of the Global Forum should form part of any assessment of the Transparency and Exchange of Information criteria under the Recommendation, and Platform members foresee no major practical or administrative difficulties in applying this approach in practice. Several MS take the Global Forum rating into account, complemented by their own evaluation based on their experience of effective exchange of Information with the jurisdiction concerned.
- **Harmful tax measures** Platform members recognised the usefulness of this criterion; they agreed that the Code criteria and existing Code assessments should be used as a benchmark for the purpose of applying the fair tax competition criterion of the Recommendation. This is also used in relation to discussions with some third countries (CH, LI). However, assessing this criterion appears onerous in terms of workload, especially for small Member States, and some suggested that this could be solved by providing or sharing reliable information.
- **Possible additional criteria**
 - Platform members agreed that existing intra-EU tax standards and regulations are important as benchmarks prior to promoting tax standards and regulations towards third countries, and reviewing internal standards is needed to raising the bar in the context of recent international developments;
 - Various views were expressed on the tax rate/effective level of taxation criterion used by some Member States. Some consider it should not be taken into account in relation to third countries since it is not currently applied within the EU, some others suggest that this should be further considered, in the light of recent OECD and EU developments.

⁶⁹ 40% of BG corporate tax rate (10%)= 4%

⁷⁰ 3/4 of FI corporate tax rate (20%) = 15%. The FI domestic tax law includes a regime on special controlled foreign corporations (CFC) by virtue of which a “grey list” is established over countries, in which the tax burden is deemed to significantly differ from the corporate tax paid by Finnish companies. The level of tax actually paid in a non-EU tax treaty country is deemed substantially lower as compared to the corresponding Finnish tax on the income if the foreign tax is, **on average**, lower than 3/4 of the corresponding Finnish tax. However, an entity in a grey list country cannot be considered to be a CFC as long as the entity itself pays taxes which are 3/5 or more of the taxes that would have been paid in Finland.

2.1.3. Possible conclusions on criteria

For comments by Platform members

- Recommendation C(2012) 8805 contains 2 sets of criteria. Ten MS (out of 18) already comply with these two criteria, since for listing purposes they use the presence of harmful tax measures criterion in combination with the one on transparency and exchange of information. The other MS apply other criteria like the tax level, either alone, or in combination with one or both criteria of the Recommendation.
- The 2 criteria provided by the Recommendation (transparency and exchange of information; fair tax competition) are the most relevant for assessing the good governance criteria. They may be supplemented by criteria on effective cooperation (i.e bilateral/multilateral instruments).
- The Commission services might also suggest to give further consideration, in the light of OECD and EU developments, to the relevance of other criteria, such as the level of taxation, in particular towards those jurisdictions having no taxation at all. In addition, since the adoption of the Recommendation, automatic exchange of information has become the norm, it would be logical to use this also as a criterion.

4.2 Lists

2.2.1. Factual elements

Information based on document Platform/11/2014/EN

Out of 28 replies received, 18 MS have a (black/white/other) listing system, 10 MS having no list at all.

CONTENT OF LISTS

1 - Blacklisted jurisdictions

The number of black listed jurisdictions ranges from 0 in DE to 85 in PT. The use of the criteria mentioned under point 1.1 *supra* gives the following results.

- Transparency and exchange of information

The 13 MS (BE, BG, DE, EE, EL, ES, FR, HR, IT, LT, LV, PL, PT)) using this criterion (solely or in combination with others) list between 0 (DE) and 85(PT) jurisdictions (see **table 1**). Only DE uses solely this criterion.

- Harmful tax measures

The 10 MS (BE, BG, EE, EL, HR, IT, LT, LV, PL, PT) using this criterion in combination with the first one result in listing between 24 (BE) and 85 (PT)

jurisdictions. However these are not always the same (see **table 2**).

Amongst the 4 MS (EE, HR, IT, PL) using only the 2 criteria of the Recommendation (see **table 3**), there are some discrepancies: 31 jurisdictions are blacklisted by these 4 MS, 7 by 3 of them, 20 jurisdictions are blacklisted by 2 MS, and 27 by only one (not always the same MS). In total, EE has blacklisted 55 jurisdictions, HR 50, IT 68 and PL 39. If we compare the 4 MS (EE, HR, IT, PL) that use only both criteria from the Recommendation, to the 2 MS (FI, SI) using the tax level criterion only, the first group (Recommendation criteria) lists between 39 (PL) and 68 (IT) jurisdictions, while FI and SI list 15 and 19 jurisdictions respectively. 10 jurisdictions blacklisted by FI and/or SI had not been blacklisted by any of the 4 MS using both Recommendation criteria only.

- Level of taxation

The 6 MS (BE, BG, EL, LT, LV, PT) using this criterion in combination with those of the Recommendation result in listing together 10 jurisdictions (see **table 4**). However, 22 jurisdictions are listed by 5 of them, 12 jurisdictions are listed together by 4 of them, 13 by 3 MS, 18 jurisdictions are blacklisted by 2 MS, and 41 by only one (not always the same MS). In total, BE has blacklisted 24 jurisdictions, BG 45, EL 58, LT 60, LV 62 and PT 85.

The 2 MS (FI, SI) using solely the level of taxation for blacklisting purposes list 15 and 19 jurisdictions (see **table 5**).

These various points show a wide range of differences between MS' evaluations when using a comparable set of criteria.

2 - White lists

There are 5 MS having whitelists (IT, EE, LT, SE, SK).

However, the IT is used for withholding tax exemptions on interest payments on bonds issued by the state banks or quoted companies and not for anti-avoidance issues. It is therefore not suggested to be considered for the purpose of this process.

Estonia (EE) has a white list of countries not considered as low tax jurisdictions as well as a blacklist. They are both used for CFC and non-deductibility of cost purposes. It is worth to note that EE white lists countries such as Bahrain (blacklisted by 8 MS), FYROM (blacklisted by 2 MS), the Isle of Man (blacklisted by 9 MS), Jersey (blacklisted by 6 MS), Singapore (blacklisted by 4 MS), Switzerland (blacklisted by 2 MS) or the United Arab Emirates (blacklisted by 8 MS).

SE has reported having a white list linked to CFC rules: in case a CFC is established in a white listed country, it is not necessary for the tax administration to perform the CFC-rules tests.

3 - Other listing system

The UK categories for offshore penalties considers the efficiency with which tax information is received from third countries.⁷¹ Category 1 includes those countries from which information is received automatically, Category 2 includes those from which information is received on request whilst Category 3 includes countries which are not compliant with EOI on Request as well as those where exchange of information arrangements are not in place.

MANAGEMENT OF MS' LISTS

- The 18 MS having lists indicated they were publicly available and provided links to their websites;
- Very few MS have a periodical review of their list, which takes place each year (EL, FR) or every 2 years (BE). The other 15 MS review their lists on an ad hoc basis. However, several updating issues have been identified.

2.2.2. Discussion in the Platform

- Non-MS members were in favour of a single EU blacklist given the difficulty in their view to achieve coherence between 28 MS blacklists, and in order to have a level playing field for all companies in all MS. One MS suggested that the Commission should assess the compatibility of Member States lists with EU law.
- However, Platform members welcomed the comparison of various lists from MS and the Commission services' suggestion to publish a consolidated version on the Platform website. They also recognised the need to improve consistency of assessments made under similar criteria.
- On transparency, Platform members recognised the usefulness of keeping lists up-to-date on a regular (i.e. at least annual) basis. They noted that this could be resource-intensive for some MS, and called for an appropriate procedure.

2.2.3. Possible conclusions

For comments by Platform members

- Those MS having no listing process have not reported they are considering adopting one.
- The Commission services might suggest solutions to improve the consistency of

⁷¹

The UK does not consider its differentiated penalty regime to be a black list since it only applies higher penalties to individuals who are found to have been non-compliant in their activities in particular countries rather triggering any measures of general application (e.g. withholding taxes).

assessments of similar criteria.

This could include sharing information on:

- effectiveness of exchange of information mechanisms with the jurisdiction concerned, in particular for those jurisdictions not having yet passed the phase 2 review of the Global Forum;
- the presence of potentially harmful tax measures detected by MS or by the Commission services.

Possible mechanisms could range from informal/multilateral ones (between MS and with Commission services), or/and with some monitoring by the Platform or by an institutionalised instance (such as an appropriate Council group).

- The Commission services might also suggest that such monitoring mechanisms could also cover the updating of MS lists, to ensure that any update from a MS would be reflected in due time in the list consolidated for publication on the TAXUD webpage.

4.3 Measures applied towards third countries

2.3.1. Factual elements

- The Recommendation contains a series of positive and negative measures (de-listing/listing with a reference to the Recommendation, initiation/termination of double tax conventions, technical assistance...) that MS may apply towards third countries, depending on whether they comply with or are committed to the minimum standards of good governance.
- Member States have not reported using two of the measures (treaty renegotiation or incentives). They have however reported using on an individual basis a number of other tax measures, such as non-deductibility of costs (11 MS), CFC rules (8 MS), and measures related to withholding taxes (10 MS).

2.3.2. Discussion in the Platform

- Platform members recognised the general relevance of the measures provided in the Recommendation as a mean to convince third countries to adopt minimum standards of good governance. However, some Platform members expressed reservations on granting incentives to jurisdictions not yet complying with minimum requirements, while other members stressed the need to strengthen EU assistance to developing countries on policy making, administrative support and capacity development.
- Platform members noted the variety of measures currently applied by MS, with 3 main categories (non-deductibility of costs, CFC, withholding taxes).
- Platform members recognised that the threat of being collectively blacklisted in combination with positive measures should often suffice to convince most third countries to comply with such standards. It was understood that practical application

of the measures needs to be proportionate and to allow flexibility based on a case by case assessment of both the seriousness of the non-compliance and of interests other than tax good governance. In this respect, some Platform members expressed concerns on the difficulty to apply on an individual basis negative measures against a big powerful jurisdiction because of the risk of countermeasures, or that countermeasures should not undermine progress on Automatic Exchange of Information.

- The Recommendation does not require coordinated actions but some discussions in the Platform underlined that collective/coordinated actions would be more effective than individual actions in relation to third countries. A coordinated action could bring some of the most problematic jurisdictions to amend certain practices.

2.3.3. Possible conclusions

For comments by Platform members

- MS have not reported having taken additional actions as a follow-up to the Recommendation. However, incidentally and as a result of their existing rules, some MS comply *de facto* with some of the criteria and a few measures contained in the Recommendation.
- The Commission services note that, while aiming at the same goals as those of the Recommendation, the fact that MS do not follow the same approach leads to additional work. They should at least cooperate to convince third countries to comply with the minimum standards of good governance in tax matters. The lack of appetite from MS to act collectively against non-compliant countries seems to be justified by 3 main reasons: the lack of resources to assess third countries' tax regimes, the lack of willingness of some MS to take action against non-compliant countries, and the wish of MS to keep a margin of manoeuvre and to decide what appropriate measures to apply to third countries.
- The Commission services note that a variety of MS measures apply to third countries without an overall consistency in relation to the minimum standards of good governance, and that some non-targeted third countries operate harmful tax measures. Based on experience shared with Platform members, the Commission services consider that limited collective action could be sufficient to convince these third countries to comply with the minimum of good governance. Efficiency of such collective action also relies on its visibility.
- The Commission services may therefore suggest an initiative for further action, aiming at third countries' effective compliance with minimum standards of good governance in tax matters (and further standards if necessary) in their relations with EU MS. This initiative would provide for further practical assistance on how to apply the content of the Recommendation. For instance, the Joint Transfer Pricing Forum successfully agrees on Codes and guidance on how to apply OECD transfer pricing rules; the Platform could contribute in a similar way. In practical

terms such (soft or hard law) initiative could:

- Provide for an assessment mechanism that could be relied upon by MS;
- Propose that MS would promote compliance with the minimum standards in their relationship with the third countries concerned, so that collective action may not always be necessary;
- Foresee minimum measures to be applied collectively, building on those of the Recommendation;
- Foresee that MS could individually adopt additional criteria and take further actions towards the third countries concerned.

4.4 Conclusion

The Commission services will take into consideration the discussion held in the Platform and written comments from Platform members when moving to the next stage of preparing a report for consideration by the Commission.

3. APPLICATION OF THE RECOMMENDATION ON AGGRESSIVE TAX PLANNING

The purpose of the Recommendation is to better enable Member States to address aggressive tax planning by reducing double non-taxation and ensuring a minimum level of protection across the EU MS by the adoption of a general anti-abuse rule taking into account the limits imposed by Union law.

The Recommendation was discussed at the Platform meetings of 16 October 2013, 6 February 2014, 10 June 2014 and 19 December 2014.

4.1 Limitation to the application of rules intended to avoid double taxation

3.1.1. Discussion in the Platform

Concerning the clause to prevent double non-taxation in double tax conventions (DTC), some MS expressed reservations on the scope, which by being too broad in their view could be used by other contracting parties to tax items that the MS concerned wanted to exempt. Some suggested that this could be prevented with a more specific (tax or jurisdiction) scope. Some members mentioned that the systematic inclusion of this clause would require the renegotiation of all Double Tax Conventions (DTC).

One MS indicated it would introduce a subject to tax clause only on a case by case basis.

Several MS and non-MS members mentioned the parallel OECD work anti-abuse rules in the DTC; and suggested to wait for the outcome of the OECD work before taking a final stance.

It seems from the discussion that no MS intends to include the recommended clause in a foreseeable future.

Several members support the CCCTB as part of the solution.

3.1.2. Possible conclusions

For comments by Platform members

- Since no MS seems to support the right to tax clause as included in the Recommendation, the Commission services intend to report that no MS has decided to follow-up the Recommendation on this point, and that there is a need to find other ways of treating this issue, having due regard to the outcome of the OECD on BEPS (notably Actions 6 (Prevent Treaty Abuse) and 15 (Multilateral Instrument text)).

4.2 General Anti Abuse Rule (GAAR)

A GAAR is a powerful means of protection against novel tax planning schemes and the common GAAR proposed in the Commission Recommendation takes account of primary and secondary EU legislation and European Court of Justice (ECJ) rulings.

The Platform agreed to collect more information from MS concerning the GAARs currently operated at national level. The replies received from MS on the questionnaire have been summarised in the Discussion Paper *Platform/12/2014/EN* for the 19 December 2014 meeting. It contains useful information on MS having (or not) a GAAR, when GAARs have been introduced and amended and on the operation of the various GAARs.

A significant new development is the agreement at ECOFIN on 9 December 2014, on a common anti-abuse rule in the parent-subsidiary directive (PSD).

3.2.1. Factual elements

Information based on document Platform/12/2014/EN

- 6 MS⁷² have indicated to support the Commission Recommendation concerning the GAAR. Three of them – **EL**, **RO** and **SK** declare having introduced a GAAR that has been drafted following the Recommendation on Aggressive Tax Planning. The other three – **HR**, **IT** and **PL** – are still in the process of following up on the Recommendation
 - **HR** replied to have the intention to review their existing GAAR, using the template of the Recommendation.
 - In **IT**, the Government has been officially charged by the Parliament to proceed with a general fiscal reform, which will be comprehensive of new anti-avoidance rule. Article 5 of the law, specifies that this new rule must be consistent with the EC Recommendation n. 2012/772/UE of 6th December

⁷² This concerns EL, HR, IT, PL, RO and SK.

2012.

- **PL** has launched a legislative initiative to introduce a GAAR in 2016 that will take into account the Recommendation.
- 4 MS are as of yet undecided⁷³. They report to still consider the question of implementing the Commission Recommendation. Some explicitly state that more clarity would be needed on the working of the Commission Recommendation and how that interacts with international developments.
- The remaining 18 MS report not to see the added value of introducing or revising their GAAR on the basis of the 2012 Commission Recommendation⁷⁴. Most of these MS consider that the GAAR or GAAR-equivalent provision that they currently have works well and/or is very similar in effect to the GAAR proposed in the Commission Recommendation. Some, such as IE, express concerns over increased uncertainty in relation to the effectiveness of their tried and tested provision if it were to be revised. Others, such as LT, are concerned that MS could interpret the Commission Recommendation differently in the absence of EU guidance.

3.2.2. Discussion in the Platform

Platform members support improving anti abuse rules support although it is important to leave some flexibility to MS.

Several Platform members expressed concerns over the GAAR recommended by the Commission, amongst others: on the manageability of a GAAR by the tax administrations (complex to use) and by taxpayers (legal uncertainty). Some guidance would be needed on the application of a GAAR. It was also observed that even if all MS adopt the same GAAR, different interpretations by different courts may still occur.

3.2.3. Possible conclusions

For comments by Platform members

- The follow-up of the recommended GAAR has to be seen in the light of the agreement on the Parent-Subsidiary directive anti-abuse rule (AAR) and as a minimum level of protection that should be adopted by all MS.
- The Commission services intend to report that MS not having taken additional action after the Recommendation consider that they already have anti-abuse rules that meet the objectives of the Commission Recommendation in tackling Aggressive Tax Planning. This might lead to further consideration and assessment on possible action to be taken.

⁷³ This concerns DK, FI, LU and SI.

⁷⁴ This concerns AT, BE, BG, CY, CZ, DE, EE, ES, FR, HU, IE, LT, LV, MT, NL, PT, SE and the UK.

ANNEX 4 RELATIONS EU ACTIONS AND BEPS INITIATIVE

Areas for EU action	BEPS action
1. CCCTB: A Holistic Solution to Profit Shifting	
<p>Relaunching the CCCTB as a means to address the current challenges in corporate taxation. A mandatory CCCTB would include rules in relation to Controlled Foreign Companies (CFC), interest deductibility, and permanent establishment (PE). In the absence of consolidation (first step), the proposal would also include transfer pricing rules.</p>	<p>Action 3 on Strengthening CFC Rules</p> <p>Action 4 on Limiting Base Erosion via Interest Deductions and Other Financial Payments</p> <p>[Action 6 on Preventing Treaty Abuse]</p> <p>Action 7 on Preventing the Artificial Avoidance of PE Status</p> <p>Action 8-10 on Assuring that Transfer Pricing Outcomes are in line with Value Creation</p> <p>Action 1 on Addressing the Tax Challenges of the Digital Economy is covered by the Action Plan as a whole.</p>
2. Ensuring Effective Taxation Where Profits are Generated.	
<p>2.1 Bringing taxation closer to where profits are generated and ensuring effective taxation of profits. Work must continue on elements in the common base which are linked to the OECD BEPS project. This would include adjusting PE rules so that companies cannot artificially avoid having a taxation presence in Member States in which they have economic activity, or improving the CFC rules. The Commission will also consider how to ensure that EU corporate tax legislation aimed at preventing double taxation (i.e. the Interest and Royalties Directive and Parent-Subsidiary Directive) does not inadvertently lead to double non-taxation.</p>	<p>Action 7 on Preventing the Artificial Avoidance of PE Status</p> <p>Action 3 on Strengthening CFC Rules</p> <p>Action 2 on Neutralising the Effects of Hybrid Mismatch Arrangements.</p>
<p>2.2. Improving the Transfer Pricing framework in the EU.</p>	<p>Action 8-10 on Assuring that Transfer Pricing Outcomes are in line with Value Creation.</p>
<p>2.3. Linking Preferential Regimes to Where Value is Generated (modified nexus approach as agreed by the Code of Conduct Group). The Commission will continue to provide guidance to Member States on how to implement patent box regimes in line with the new approach, and carefully</p>	<p>Action 5 on Countering Harmful Tax Practices. The first work stream of Action 5 relates to the review of patent box regimes.</p>

monitor implementation.	
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3. Additional Measures for a Better Tax Environment for Business.	
3.1. Enabling Cross Border Loss Offset.	No related BEPS action
3.2. Improving Double Taxation Dispute Resolution Mechanisms. The Commission will propose improvements to the current mechanisms to resolve double taxation disputes in the EU.	Action 14 on Making Dispute Resolution Mechanisms more Effective addresses the obstacles that prevent countries from resolving dispute through the Mutually Agreed Procedure (MAP).
4. Further Progress on Tax Transparency.	
Beyond the measures already proposed by the March Transparency Package, the Commission has identified further measures to boost transparency, both in relation to the EU and in relation to third countries.	Action 5 on Countering Harmful Tax Practices. The second workstream of Action 5 relates to spontaneous exchange of information on tax rulings.
4.1. Ensuring a more Common Approach to Third Country Non Cooperative Tax Jurisdictions. Beyond the work already done by the Platform on Good Governance, further work in screening third countries for compliance with tax good governance standards is also necessary. The Code of Conduct Group would be the most appropriate forum to do this.	Action 5 on Countering Harmful Tax Practices. Action 5 includes a strategy to expand participation to non-OECD countries.
4.2. Proceeding with work on corporate tax transparency, including country-by-country reporting options. This could include making a limited set of tax information of multinational companies publicly accessible.	Action 13 on Re-examining Transfer Pricing Documentation. However, the OECD reporting template is only intended for tax authorities (and not for public disclosure).
5. EU Tools for Coordination.	
5.1. Improving Member States' Coordination on Tax Audits	No BEPS related action.
5.2. Reforming the Code of Conduct for Business Taxation and Platform on Tax Good Governance	No BEPS related action.