BETTER GOVERNANCE THROUGH MORE TRANSPARENCY ON ADVANCE CROSS-BORDER TAX RULINGS

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Abstract

In recent years, the challenge posed by tax fraud and tax evasion has increased considerably and has become a major concern within the European Union. As a consequence, in the European initiatives a special emphasis has been laid on the actions aimed at reinforcing the anti-abuse provisions in bilateral tax treaties, national legislation and EU corporate legislation. Any artificial arrangement carried out for tax avoidance purposes would be ignored and companies would be taxed instead on the basis of actual economic substance. The aim of the article is presenting the European initiative aimed at implementing the automatic mode of the exchange of information on cross-border tax rulings and advance pricing arrangements. The paper investigates if the implemented measure can help Member States to detect certain abusive tax practices taken by companies, and to take the effective actions in response. It also tries to answer the question whether the initiative can result in more transparency and – as a consequence – in much better governance, both at the states' and the corporations' level.

Keywords: Tax Evasion, Transparency, Automatic Exchange Of Information, European Tax Policy

1. INTRODUCTION

The worldwide perception of taxes is evolving. For many years an old saying *"there are two certain things in life: death and taxes"* was treated by the international business as a sentence that applies only to individuals. The main goal of each business – to increase the value of the enterprise – resulted rather in tax optimisation practices, than in the policy of "corporate tax responsibility". However, the economic crisis has brought the discussion over the fair share of taxes to be paid from the income generated in the source country to the upper level. The arguments of paying the fair price in return for deriving money from the local activity and using the local infrastructure began to be recognised also by business – particularly the international one. News about low amounts of taxes (or no taxes at all), which were (not) paid to the state's budgets due to the wide use of subsidiaries, registered in low tax jurisdictions, caused reactions of developed countries, suffering from the erosion of their tax bases. The OECD has conservatively estimated that USD 100-240 billion is lost due to the global profit shifting every year – an equivalent to between 4% and 10% of global corporate tax revenues. The European Parliamentary Research Service put the revenue lost to corporate avoidance at around EUR 50-70 billion a year in the EU (European Commission, *The Anti Tax Avoidance Package...*, 2016).

In recent years, the challenge posed by tax fraud and tax evasion has increased considerably and has become a major concern within the European Union. As a consequence, in the EU initiatives a special emphasis has been laid on the actions aimed at reinforcing the anti-abuse provisions in bilateral tax treaties, national legislation and EU corporate legislation. Any artificial arrangement carried out for tax avoidance purposes would be ignored and companies would be taxed instead on the basis of actual economic substance (European Commission, 2012). A special attention has been directed also to so called "tax rulings", used by several EU Member States.

2. LITERATURE REVIEW AND METHODOLOGY

Within years some researchers investigated tax rulings as measures used in order to mitigate tax uncertainty and foster investment. C. Romano (2002) presented a comprehensive overview of such legal instruments and brought closer the practices of tax rulings in selected EU Member States. W. Eynatten (2008) in his comparative study looked at the tax rulings as a part of a whole tax systems that sometimes allow multinational enterprises for

obtaining (a partial or even a total) tax exemption of their duties. He particularly stressed the importance of special tax regimes for intellectual property income, used in such EU countries as Belgium, Netherlands, Luxembourg, and Ireland.

At the same time Y. Givati (2009) concluded that despite the fact that providing empirical evidence of tax law uncertainty, which should give rise to a demand for advance tax rulings, such instruments are in fact infrequently used. In order to explain this counterintuitive finding he analysed the taxpayers' strategic considerations in the process of deciding whether to request an advance tax ruling, and found out that the strategic disadvantages of applying for a tax ruling are shown usually to outweigh the strategic advantages of such a request.

The confidential documents about the Luxembourg (secret) tax rulings, revealed by the International Consortium of Investigative Journalists, inspired Huesecken and Overesch (2015) to a study, in order to tests the effect of tax rulings on the tax avoidance of multinational enterprises. They found out that after engaging in the tax ruling, firms achieve lower effective tax rates compared to non-ruling firms. Their study gave evidence for tax avoidance through a newly made public, legally-assured tax shelter.

The Lux Leaks scandal provoked also some legal considerations. Christians (2014) argued that ICIJ investigation demonstrated that international tax law involves multi-directional confidences, both between taxpayers and their own governments, and in governments' dealings with one another. She pointed that the excessive protection of multinational taxpayers' confidentiality resulted in trading the idea of a public trust. As the consequence of such phenomena was not only tax benefits for a small but influential group of MNEs, but also potentially high costs for far more numerous groups, Christians stressed the need for changes. She argued that too much secrecy is unsustainable in tax governance. Instead, allowing public monitoring of the ways governments serve specific taxpayers and resolve international tax disputes could start rebuilding the trust, lost in opaque actions.

The recent years' considerations of academics inspired to the study on the European initiatives, aimed at increasing the transparency and rebuilding the public trust, weakened in harmful tax competition scandals. In the research the analysis of available source materials was concluded. The literature overview and the study of documents and reports delivered by the International Consortium of Investigative Journalists were followed by the analysis of the European Commission and the European Parliament's documents. The whole process was supplemented by the overview of papers, reports and statements of international organisations, professionals and NGOs.

3. TAX RULINGS AS HARMFUL MEASURES

Tax rulings as such are perfectly legal. They are comfort letters by tax authorities giving specific company clarity on how its corporate tax will be calculated. In particular, they are used to confirm transfer pricing arrangements, i.e. the prices for goods sold or services provided by one subsidiary of a corporate group to another subsidiary of the same group. This influences the allocation of the group's taxable profit between its subsidiaries located in different countries. As such, tax rulings are not problematic. However, there is also an issue of so called "secret tax rulings", for years used by some EU Member States. In order to attract foreign direct investments, these countries allow special tax treatments for individual companies, especially multinational enterprises (MNEs). Cyprus, the Netherlands, and Luxembourg are known worldwide for those practices (Obry, 2014).

In the process of arranging a tax ruling there are some standard steps, to be taken in order to set up the special tax treatment. Multinational enterprise refers to the tax authorities of a given state with a question about the tax rate to be demanded, in case of setting up a subsidiary at the states' territory. With the help of its legal department, a law firm or an audit firm, MNE drafts a business process and proposes a tax rate, to be levied in case of realising the project. Confirmation of the legality of the company's offer, made by the tax authorities, results in tax ruling (usually the secret one), which is valid for the next years. What is important, the projected subsidiary gathers majority of the income from other countries, which leads to minimising the overall tax rate paid by the MNE from its overall European activity.

EU Member States argued that secret tax rulings are harmful, as they not only erode national tax bases of other EU States, but also can lead to artificial capital flows and movements of taxpayers and thus harm the proper functioning of the European internal market. Moreover, such practices distort competition and put in unfavourable situation less mobile businesses. Cross-border companies pay on average 30% less tax than the entities active in only one country, whereas it is small and medium-sized enterprises that are the primary job creators in Europe (as in the past five years they have created around 85 % of all new jobs in the EU). Further escalating of these inequalities between local and global business can lead to more distortions of competition, losses of jobs and – in the consequence – hinder sustainable growth in European Union (European Parliament, 2016).

4. LUX LEAKS AND THE EC COUNTER MEASURES

2014 has brought events that proved to be the catalyst for more decisive actions at the European Union level. In November the International Consortium of Investigative Journalists (ICIJ) revealed the "Lux Leaks", involving 28 000 pages of leaked confidential information. The information included tax rulings granted by the Luxembourg authorities to over 340 multinational companies, dating from 2002 to 2010. In December there came a second tranche of news – ICIJ revealed new names of about 30 large companies benefiting from tax rulings and tax avoidance schemes in Luxembourg. The new files also showed that the tax deals were brokered by PwC, Ernst & Young, Deloitte and KPMG, among other accounting firms.

Tax rulings were entirely legal but have caused tumultuous reactions of politicians from other EU Member States, who argued that such measures deprived them of significant tax revenues (Holehouse, Samuel, 2015). They pointed that it is not a matter of reducing companies' tax burden to a very low rate,

plus the difficult interactions of many national tax systems anymore, but a problem of private "comfort letters" provided to corporations seeking favourable tax treatment. Especially, that in many cases Luxembourg subsidiaries handling hundreds of millions of dollars in business, maintained little presence and conducted little economic activity in Luxembourg (over 1 600 companies registered under one Luxembourg address was a good example of this phenomenon).

One of the samples given by ICIJ was the Disney-Luxembourg "comfort letter" that had all characteristics needed for achieving both: the favourable tax treatment and the secrecy. The 34-step advance tax agreement was proposed in October 2009 by Ernst & Young. The document showed that the corporation moved money in circles across the globe while transforming it from cash to debt to equity and back. The copy of the ruling obtained by ICIJ did not bear the stamp of approval of the Luxembourg tax authority, but the ICIJ was able to verify, based on the company's public filings in Luxembourg, that the actions outlined in the document took place in reality (Fitzgerald, Walker Guevara, 2014).

Lux Leaks scandal erupted shortly after the position of the EC President was taken by J. C. Juncker – a former prime minister and finance minister of Luxembourg. In his "defence" before the European Parliament's Special Committee on Tax Rulings, Juncker denied any role in secret tax deals to multinational companies at the time of governing the country. He also pointed that in fact, the tax ruling practice should be named "EU Leaks" rather than "Lux Leaks", as this is not a phenomena that only happens in Luxembourg (Crisp, 2015). As a consequence, it became clear to the public that secret tax rulings' practices were used also by other European countries.

Lux Leaks resulted in EC's decision to start a broader inquiry into whether tax policies of Luxembourg and other EU Member States are compatible with the European law or, instead, they give rise to the State Aid issues[1]. 2014 European Commission's in-depth investigations into individual tax rulings relating to transfer pricing arrangements in Luxembourg (Fiat Finance and Trade, Amazon, McDonald's), the Netherlands (Starbucks) and Ireland (Apple) were next extended to all Member States.

The scandal of Lux Leaks occurred to be the argument which triggered the European initiatives towards minimising the aggressive tax optimisation. Germany, France and Italy demanded more severe measures to be implemented in order to stop the aggressive (and so far legal) practice of international corporations. In the explanation to the projected EU actions, J. Almunia, the EC Vice President in charge of competition policy, said: *"National authorities must not allow selected companies to understate their taxable profits by using favourable calculation methods. It is only fair that subsidiaries of multinational companies pay their share of taxes and do not receive preferential treatment which could amount to hidden subsidies"* (European Commission, 2014).

The main focus of projected actions was put on transparency and non-selectivity in companies' (tax) treatment, as a paradigm of EU State Aid rules. The case was not to forbid the tax rulings, but to significantly decrease the opacity of a whole system. As a consequence, on 18 March 2015, the European Commission published a proposal introducing a mandatory automatic exchange of information on advance cross-border rulings and advance pricing arrangements. The disclosure requirement included not only the future tax rulings, but also old, but still existing arrangements. As the tool for setting out practical arrangements for exchanging information, the Directive on administrative cooperation in the field of taxation between Member States (Directive 2011/16/EU) has been chosen.

5. NEW ORDER IN CROSS-BORDER TAX RULINGS

The old version of the Directive on administrative cooperation in the field of taxation already provided for the mandatory spontaneous exchange of information among EU Member States, but in reality countries shared little data with one another about their cross-border tax rulings. It was at the discretion of the country itself to decide whether a tax ruling might be relevant to another EU Member State. In practice the efficient spontaneous exchange of information took place rather rarely. The amended Directive 2015/2376, agreed by the EU Member States, implements the duty to automatically exchange the information on the above mentioned tax rulings. The new rules remove Member States discretion to decide on what information is shared, when and with whom.

New rules define the tax rulings quite widely, in order to capture all similar instruments and irrespective of the actual tax advantage involved, as any communication (or other instrument or action of similar effect), given by or on behalf of a Member State, regarding the interpretation or application of its tax laws. The scope of the automatic exchange includes advance cross-border rulings and advance pricing arrangements, of any material form, irrespective of their binding or non-binding character and the way they are issued. The Directive also covers existing rulings of the past five years. Certain conditions allow for excluding from such mandatory exchange particular persons (or groups of persons), with a group wide annual net turnover of less than EUR 40 million.

Member State should inform each other on the individual tax arrangements, presenting the summary of the tax ruling and providing data allowing for the identification of the persons to which the company belongs. The exchanged data should include the date of issuance (amendment or renewal) of tax rulings and the period of their validity. Together with the type of the tax ruling also the description of the relevant business activities and transactions should be provided, with the set of criteria used for the determination of the transfer pricing, plus the identification of the method used for setting the price. The information should also cover the list of EU countries that can be concerned in the tax ruling and – if possible – the identification of the entities in other Member States that can be affected. The Receiving State may also request (in justified cases) some

[1] State Aid is the advantage granted by public authorities through state resources on a selective basis to any organisations that could potentially distort competition and trade in the European Union; as such is prohibited (see more: Art. 107 TFEU; www.ec.europa.eu/competition/state_aid/overview).

additional information, including the full text of an advance cross-border ruling or an advance pricing arrangement.

In order to enhance the international cooperation between EU countries, the Receiving State should send a feedback on the automatic exchange of information that was obtained from the Sending State. In practice, this mandatory feedback should be done by arrangements agreed upon bilaterally on annual basis.

Moreover, the automatic exchange of information on tax rulings, foreseen in the amended Directive will take place not only between all Member States, but also with the European Commission. The role of the Commission would be monitoring and evaluating the effective application of the mandatory automatic exchange of information on tax rulings, and compliance with the responsibilities of individual EU States. Member States have time to implement the new measures to their national laws by 31 December 2016; the Directive will take effect from 1 January 2017.

6. CONSEQUENCES FOR MULTINATIONAL ENTERPRISES

The new rules foreseen in the amended Directive will not bring changes to the legal position of entities that conclude tax agreements with EU Member States. Taxpayers still will be entitled to rely on advance cross-border rulings or advance pricing arrangements – especially during taxation processes or tax audits – under the condition that the facts on which the advance tax ruling is based has been accurately presented and that the taxpayers abide by the terms of the ruling. The countries will exchange the information irrespective of whether the taxpayer abides by the terms of the cross-border tax ruling. What is worth mentioning, the provision of information should not lead to the disclosure of a commercial, industrial or professional secret or of a commercial process, or disclosure of information which would be contrary to public policy.

The automatic exchange of information in tax rulings which is to be implemented between EU Member States gains the importance in the light of the European Commission's decisions, taken in the investigations into individual tax rulings between MNEs and some EU Members: Luxembourg, the Netherlands and Ireland. In October 2015, the European Commission concluded that Luxembourg had granted selective tax advantages to Fiat, and the Netherlands to Starbucks. January 2016 brought next verdict, stating that selective tax advantages, which were granted by Belgium to least 35 multinationals, under its "excess profit" tax scheme are incompatible with the EU State Aid rules. The Commission estimated the total amount to be recovered from Belgian companies to be around EUR 700 million (European Commission, *State aid: Commission concludes...*, 2016).

The most serious consequence of the in depth investigations was the EC decision concerning the Apple case. On 30 August 2016 Apple was ordered to pay a record EUR 13 billion in back taxes in Ireland. The European Commission stated that concluded arrangements were selective treatment and gave illegal tax benefits that, in the result, allowed Apple to minimise an effective corporate tax rate on its European profits from one per cent in 2003 to 0,005 per cent in 2014 (with the standard corporate tax rate in Ireland fixed at 12%) (European Commission, *State aid – Ireland...*, 2016).

According to tax professionals, multinational companies can expect the European Commission to press on with severe measures, implemented in order to restrict the influence of secret agreements. The automatic exchange of information on cross-border tax rulings together with the EC's in depth investigations focusing on existing agreements can constitute a strong disincentive for the use of harmful tax competition measures. In the result the race to the bottom trend, observed in tax rates paid by MNEs during last 15 years, could be stopped or at least slowed down.

7. CONCLUSION

At the end of 2015 the EU Member States decided on the implementation of the automatic exchange of information on cross-border tax rulings. The new rules allow Member States ask for more detailed information on particular tax arrangements. The automatic mode of the exchange of information should help Member States to detect certain abusive tax practices by companies and take the necessary actions in response. It is expected that this initiative will deter tax authorities from offering selective tax treatment to companies once this is open to scrutiny by their peers. This should result in much healthier tax competition.

There is also other interesting aspect, which arose in relations between EU Member States and the powerful global business. November 2015 brought the invitation for the multinational enterprises to take part in TAXE Forum – the meeting of the European Parliament's Special Committee on Tax Rulings. The aim was to give MNEs the possibility to share their positions, before the final vote on Parliament's Committee recommendations for fairer tax competition in the EU was taken. In the result eleven multinational corporations accepted the invitation and attended the TAXE Meeting. Second meeting and the exchange of views with MNEs took place in March 2016, when international companies, as well as representatives from offshore jurisdictions, joined the Special Committee on Tax Rulings to discuss taxation and developments within the EU and internationally in this field, including the OECD's Base Erosion and Profit Shifting Action Plan[2].

This new initiative of joint open meetings, if developed, could be the step forward in establishing a new standard, which will bring more transparency and certainty in relations between EU Member States and the multinational corporations. If succeed, it can result in enhancing the governance, both at the states' and corporations' level.

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[2] Transparency in tax affairs is also one of the pillars of the OECD's Base Erosion and Profits Shifting project (BEPS). The project refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity. The package, which provides 15 Actions to tackle BEPS, is in the implementation phase and will involve significant changes to domestic and international tax rules (see more: http://www.oecd.org/tax/beps/)

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