Federation of European Accountants
Fédération des Experts comptables Européens

The Tax Policy Debate: A Matter for Society as a Whole

FEE fosters the debate with stakeholders

Long version
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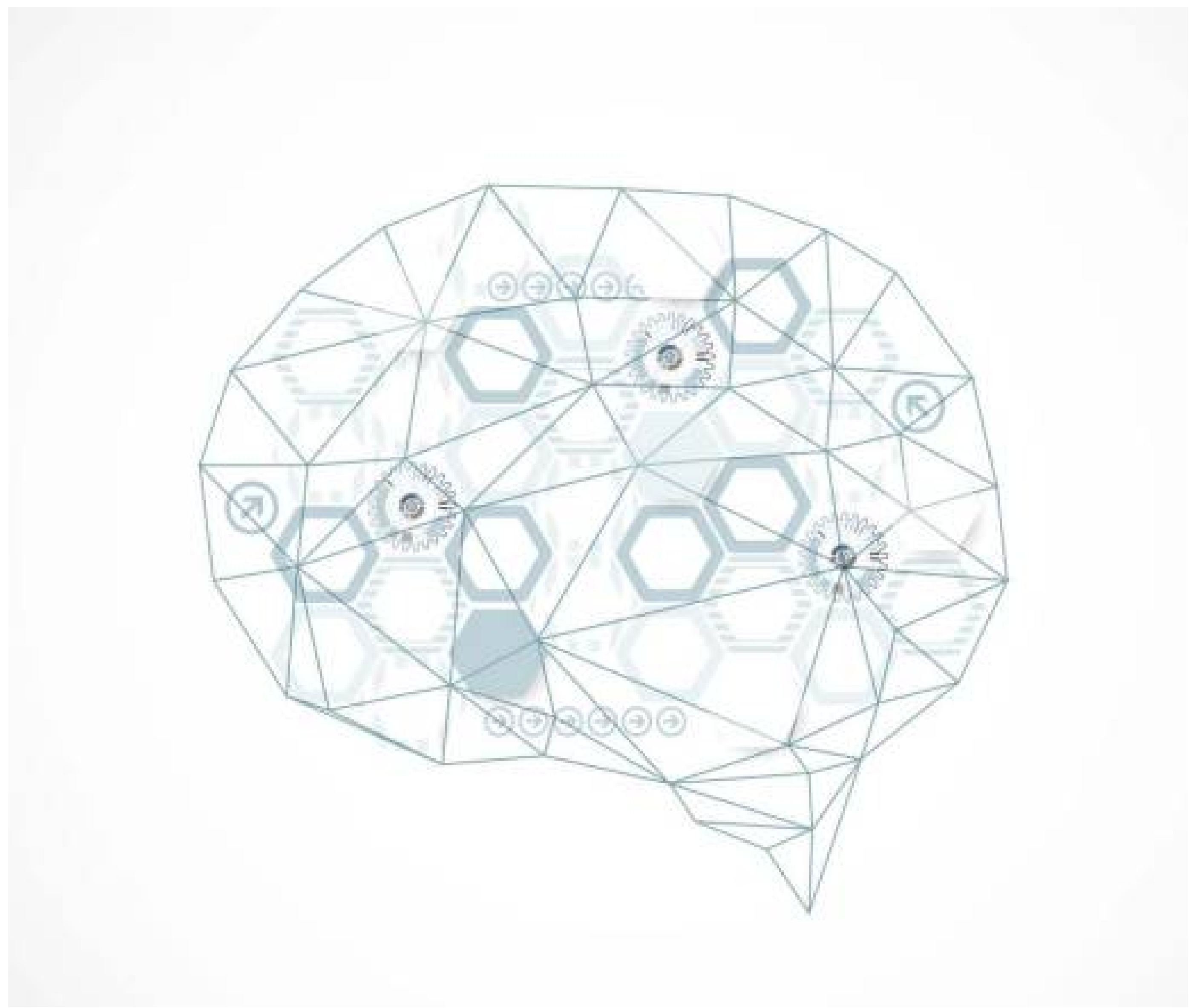

COGITO

This document is part of the *Cogito series*, a selection of thought-provoking publications by the Federation of European Accountants (FEE).

Cogito (i.e., I think) is set up to provide new ideas for the European accountancy profession. With this series we aim to enhance innovation and our contribution to business and society.

This publication aims to stimulate debate; the views expressed thus do not reflect the official positions of FEE or any of its 47 member bodies.

Foreword by FEE

Even by the standards of today's fast-paced world, the speed at which taxation has become a key topic of public disquiet has surprised business, governments, regulators and the accountancy profession.

Many parties are calling for quick solutions but with so many divergent views being aired it is difficult to achieve a common agreement on the best way forward. As one of the contributors to this publication states, the public debate has generated much noise but not a great deal of light.

It was for this reason that we decided to embark on a project to produce a publication that had the aim of bringing together a broad array of stakeholders' views, based around the belief that the future of tax policy really is a matter for society as a whole. We firmly believe that consensus is impossible unless the views of all sides of the argument have been heard. It is our hope that this publication can help stimulate debate and facilitate the development of such a consensus in the future.

Since the beginning of this project in the spring of 2014, the importance of the debate on tax policy to society as a whole has not diminished by one iota. On the contrary, it is a matter that has grown in importance at a time where many countries struggle with excessive debt and many of the world's economies have not yet fully recovered from the crisis.

Our ambition of collecting articles from all of the stakeholders has not been entirely achieved. Tax policy is a sensitive topic and not everyone is comfortable with the idea of expressing a view and looking into what is, in reality, not the future but rather already our present. The change in public opinion and demands that policymakers, lawmakers, business and professionals currently have to face is unprecedented. Civil society has been instrumental in driving this change. This debate will continue. However, thanks to the broad range of contributions we have received, the publication does provide some valuable insight into the current and future challenge for taxation policy in Europe

There are certain common themes that run throughout many of the pieces received. It seems that the tax structures and systems used by many countries are not fit for purpose. There are various reasons for this. An emphasis on taxes on employment, the bedrock of the tax system for many developed countries, is seen as stifling the growth that is so essential to move many nations out of their current moribund economic situation. A move towards taxes on "undesirable" behaviour (such as pollution) and unearned income are amongst the solutions suggested.

It is also recognised that given the increased complexity, mobility and digitalisation of the world economy, it is no longer possible for nations, whatever their size, to try to deal with these issues in isolation. Increased international cooperation is seen as the key. To some extent, we are already seeing the fruits of enhanced cooperation in the enormous effort that the OECD's BEPS team are making in trying to design an international tax structure fit for the 21st century and beyond. Yet some contributors do not consider even this level of cooperation to be satisfactory, pointing out that developing nations are underrepresented in the project

even though they are often the most badly affected by tax evasion and avoidance and by tax competition between countries.

Many contributors believe that increased transparency is part of the solution to the current debate. In this context, transparency has many facets. There has been an increasing move towards automatic exchange of information between nations, largely driven by the United States' FATCA legislation, in order to combat tax evasion. As many national governments have been cutting resources to their tax authorities, these measures are seen as cost-effective because they have been effectively delegated to the private financial sector. The issues arising from this approach are highlighted by two contributors.

Increased transparency, especially in respect of country by country reporting of tax information by multi-national businesses, is seen by national governments and civil society as an important measure in combatting tax avoidance. Business is not necessarily hostile to this as long as it doesn't result in a competitive disadvantage. There is, however, a considerable expectation gap between civil society (who want such information to be on public record) and the current initiatives (which provide for such information to only be available to tax authorities). Business is concerned that any publically available information is genuinely informative in showing whether or not a company's tax obligations have been met. Given the complexity of tax legislation this is not necessarily an easy task.

Also discussed is what could be termed "inescapable transparency" i.e. the potential that Big Data has to make it easier for tax authorities to identify tax evasion and tax avoidance through the judicious use of information technology. In fact, increased development of information technology is often highlighted as a key weapon in the fight against tax evasion and tax avoidance but also a crucial tool for taxpayers to ensure compliance with their taxation obligations.

There is a common acceptance that increased use of technology in all areas is essential for the development of a modern tax system. There is also agreement that the fight against tax evasion and fraud is a key priority and essential to the maintenance of public finances. In respect of the discussion regarding tax avoidance, however, there is little agreement.

Many still believe that if a tax planning method is legal then it is not only legitimate but it may even be a duty for business to use it. Certain national courts hold advisers liable if they don't advise their clients on the most effective tax treatment. The taxpayers involved often state that if governments do not wish such tax planning opportunities to be available then they should change their legislation. At the other end of the scale, others call on tax payers to consider social fairness when considering their tax planning and highlight the necessity for all taxpayers to make a fair contribution to the public services from which they benefit.

As highlighted by several contributors, it has long been accepted that taxpayers are entitled to arrange their affairs to reduce their tax liability by legal means. Governments frequently provide tax payers of all types with specific means to do so. Thus, tax planning is legitimate but the apparently unanswerable question concerns the point at which tax planning crosses the line and appears to be unacceptable.

Societal consensus on these matters is not helped by the increasingly unclear use of terminology and by confusion in the roles of the different parties. We therefore found it helpful to first provide the readers of this publication with some background, particularly in respect of

commonly used terms and how the different parties interact in the tax system. The articles themselves are arranged to highlight the past and current issues, to indicate how individual countries and international organisations have tried to deal with these issues and then to consider different alternatives for the future.

FEE would like to extend our warmest thanks to all those contributors to our publication. They cover a wide variety of topics around the theme of tax policy and, as requested, cover issues that the contributors feel strongly about.

We at FEE hope that this series of articles will be a useful step to advance this delicate debate. It is however only a first step. As indicated by the several articles received from professional accountants, we believe that the accountancy profession, employing its technical expertise and real-world experience, is both willing and able to play a key role in helping all stakeholders develop solutions that will be in the public interest. (Brussels, April 2015)

Clarifying matters – an introduction by FEE

Before moving on to the contributors' articles, we felt that it would be useful to clarify certain aspects of the debate that may have become somewhat obscured in the heat of the recent debate. In the first section we will try to demystify terms such as tax evasion and tax avoidance, and, in the second section we will examine the respective roles and responsibilities of the main parties in the tax system.

Introduction

Taxation is essential to the functioning of a society. Indeed, it could be argued that taxation is one of the earliest signs that a civilisation has developed, as it permits the financing of common facilities and of government itself. Consequently, the manner in which tax is levied and administered has always been a vitally important question for society as a whole and this is truer today than ever before.

This question is also becoming increasingly difficult to answer. Given the increasing globalisation of exchanges, companies' strategies and business models have become increasingly transnational. The traditional linkage of a business to a territory is vanishing and it is more and more difficult to associate companies with a home country or nationality.

Clarifying the Terminology

The recent public debate has primarily focused on the issue of tax avoidance, particularly in the context of multi-national businesses and high net worth individuals. In some countries this has resulted in taxpayers and their advisors being summoned to give public explanations of their tax planning activities. Confidential tax information has been leaked and made available to the public. The public has shown an unprecedented interest in the subject and this has even led to calls to boycott certain businesses on the basis of their tax practices. Governments have not escaped this public pressure; several countries have changed long-standing tax policies or introduced new taxes to address concerns of their voters and their fellow governments and to close what are perceived as loopholes.

Unfortunately, in the course of this public debate there has been a further blurring of terminology, which was far from clear in the first place. This has especially affected the use of the terms "tax evasion" and "tax avoidance". Consequently, in order to provide some more clarity, we will give our understanding on what is meant by tax fraud, tax evasion, tax avoidance and tax planning.

At first glance, determining what legal and illegal activities are should be easy. Yet, in most countries tax law has become increasingly complex and difficult to understand even for tax experts. Tax law is subject to ever more frequent change as legislators try to cope with new developments in business and technology. However, on a global scale, tax law varies considerably between countries as it reflects political choices and preferences - what is within the law in one country may be forbidden in another. There may also be a distinction in some countries between breaches of civil law and of criminal law, with the latter carrying heavier penalties and more public stigma. Also many countries use a mix of civil and case law in their tax legislation and this can lead to rapid shifts in what constitutes legal and illegal behaviour.

Illegal Activities

Tax evasion and Tax Fraud

Tax evasion is using illegal means to avoid paying tax and is a term more widely drawn than tax fraud. Such behaviour could include failure to record trading income, failing to declare interest on overseas investments and evading property taxes by receiving some of the sale proceeds in undeclared cash.

Tax fraud, where separately defined from tax evasion, is a criminal offence. It is often defined as the deliberate, active and planned misrepresentation of certain information leading to the perpetrator reporting a lower (or no) tax liability. Such fraud may, or may not, include falsification of underlying papers and evidence but often involves a deliberately incorrect statement on an official document, such as an income tax return.

There should be no doubt in the minds of the public, of legislators, regulators and of our clients that the accountancy profession condemns tax evasion and tax fraud and will not idly stand by when such activity is perpetrated by others. The accountancy profession strongly opposes the shadow economy and willingly plays its part in fighting against it and the inequalities that it creates.

Legal Activities

Tax planning and tax avoidance

Tax planning, to quote the OECD's definition, is the "arrangement of a person's business and/or private affairs in order to minimize the tax liability". Tax planning is legal, which has been confirmed on numerous occasions in many courts of law.

On the other hand, trying to distinguish between tax planning and tax avoidance is far less easy. To again quote the OECD, tax avoidance is "a term that is difficult to define but which is generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow." Much of the "noise" in the public debate has been around the unclear term of avoidance. Tax avoidance and evasion are often spoken of in conjunction and sometimes interchangeably. This is not correct. Tax evasion is illegal and tax avoidance is legal.

One of the difficulties in separating tax avoidance from "acceptable" tax planning is trying to discern what the intent of the law is. This intent is often not specifically stated in the legislation and, where such avoidance arises out of cross-border planning, there may not even be specific law that deals with the situation in question. Indeed, tax competition between countries, often regarded as the emanation of sovereignty and crucial in attracting foreign direct investment, provides the means for tax avoidance strategies.

Perhaps as a result of this, there have been increasing moves to differentiate tax planning from avoidance by reference to fairness and morality. Taxpayers are increasingly being told that tax avoidance is now socially unacceptable and that tax should be paid at a level that is "fair" for society. However, there is no universal acceptance of what a fair level of tax is, so it is left to taxpayers to make that judgement themselves. If the taxpayer makes an error in that judgement, a significant negative impact on their reputation may result.

As tax avoidance derives from taking advantage of the incentives and opportunities offered by tax law, better legislation and better co-operation between countries are essential to reduce such opportunities but, realistically, these are probably long term objectives.

In any event, even with better legislation taxpayers will still need to consider the reputational harm that they may be exposed to if their tax planning activities are viewed as tax avoidance. They need some guidance in order to be able to assess the risk inherent in their planning.

Perhaps one approach is to consider the degree to which the transaction or structure is based on genuine business reasons and economic substance. Transactions and structures that appear artificial (i.e. based on a series of pre-ordained steps that have no commercial rationale other than the avoidance of tax) are likely to be classified as tax avoidance and thereby may cause reputational harm for both the taxpayers that use them and the jurisdictions that permit them.

Clarifying the Roles and Responsibilities

One of the factors that makes consensus on tax policy persistently difficult to achieve is that tax involves many different players: legislators, taxation authorities, taxpayers and tax professionals. Nowadays, all are under unprecedented scrutiny from civil society that has focused on tax issues like never before.

The Role of Legislators

The role of legislators is, on behalf of their electorates, to draft laws that set the obligations of the tax payers and provide the taxation authorities with the necessary framework in order to collect the "right" amount of tax. In an ideal world, this would be achieved by an integrated and fair taxation system that is clear in its intention, easy to understand, stable over time and that follows a logical pattern.

Legislators are also supposed to ensure that tax law applies equally to all tax payers. The vast majority of citizens in most countries pay the correct amount of taxation, often automatically by deduction at source. Governments will lose credibility with their citizens, with a consequent reduction in tax morale, if the perception is that some sectors of society are above the law or that certain taxes can be escaped if one has sufficient resources.

FEE also believes that it should not be left to taxation authorities, taxpayers, their professional advisors and the public to decide what constitutes aggressive, and conversely, acceptable tax avoidance/planning. If legislators do not wish their legislation to be interpreted in a certain manner then that legislation should be changed to clarify the intent and remove the opportunity for misinterpretation.

The Role of Taxation Authorities

The role of taxation authorities is to administer the taxation system and to collect the tax required by law and this will include enforcement action where necessary. The amount of tax collected should be the amount mandated by the legislation – no more, no less. If the amount of tax due is unclear from the law, then the law should be changed so that it is clear. Clarity in legislation is an essential element of a fair tax system and in improving tax payer compliance.

Taxation authorities should not interpret legislation outside of the original intentions of legislators. They need to accept that the vast majority of taxpayers and their advisors are honest and have a genuine desire to fulfil their obligations. However, taxation systems are complex and taxpayers, particularly when trying to fulfil their obligations without engaging a tax advisor, do make errors. When such errors are made, taxpayers must be able to correct them without fear of being treated as criminals. If taxation authorities want all taxpayers to abide by the legislation then they must also demonstrate ethical behaviour.

The Role of the Taxpayer

The role of the taxpayer is to pay the amount of tax that is due according to the law – nothing more, nothing less. In order to do this they need to be able to determine the amount of tax, and this, as stated, requires clear tax legislation. They are entitled to plan their affairs to pay the minimum amount of tax required by law.

However, nowadays tax planning can have a significant negative impact on reputation, which can also subsequently have a serious financial impact. Taxpayers are part of society; in particular, where they benefit directly or indirectly from the services financed through the collection of taxes. If they benefit from these services, directly or indirectly, there is now a perception that should also make a fair contribution to them. Social responsibility is no longer just words in a glossy brochure.

Finally, taxpayers need to appreciate that tax evasion and tax fraud are not victimless crimes – if they are not paying their proper share then the burden moves to other taxpayers. Tax evasion can have a very real financial impact on the misbehaving taxpayer and may lead to long-term, financially damaging, reputational harm. Fostering a culture of compliance with tax laws rather than tax evasion, may, in certain countries or sectors of society, require long term behavioural changes that cannot be achieved unless all sectors of society are seen to lead by example.

The Role of the Professional Accountant

In most countries, professional accountants are vital to the smooth running of the taxation system as taxation systems are too complex for all but the most sophisticated of taxpayers to understand. The profession also provides invaluable assistance to taxation authorities in managing tax administration and collection – for instance in the realm of information technology, which is becoming a key factor in the efficient operation of a taxation system. Similarly the accountancy professional plays a vital role in assisting policy makers in both determining the costs of their programmes and in the creation of new tax legislation.

The arena for taxation services is a crowded one. Depending on the national legal environment, professional accountants, certified tax advisors, lawyers, banks, and even people with no relevant qualifications can provide taxation advice. What distinguishes professional accountants from the other players is the combination of a global set of ethical standards and a commitment to taking the public interest into account. This is certainly not meant to ignore the ethical standards of many other professions, but to indicate that professional accountants have for long been striving for global consistency in their ethical standards.

Depending on the different national regulatory frameworks, the professional accountants may interact with taxation systems in many different capacities. Professional accountants provide advice on the proper application of tax law, prepare tax computations and tax returns for their clients and may represent the client in case of dispute with the taxation authorities. Auditors review their clients' tax calculations and tax policies and assess their impact on the truth and fairness of the financial statements. In all these ways, professional accountants make a fundamental contribution to the reliability of the tax system and the tax base.

The legal framework in which taxation advice is given varies significantly across Europe. In some countries the provision of tax advice is regulated, subject to public oversight and strict professional laws. In others, it is unregulated by government. In all countries, however, where professional accountants provide tax planning it is on the basis that they have undertaken professional

examinations and are subject to a code of conduct and monitoring by their professional body.

Professional accountants have a duty of care to act in their clients' best interest. Nowadays, however, best interest is not solely to be measured in financial terms but also in terms of managing risk. Reputational damage could result, for both the client and the accountant, by participating in planning that is perceived as unfair. This risk should be carefully considered as part of the tax planning process. In a world of unprecedented transparency and near instantaneous communication, not all of which is well informed, reputational damage can have a direct impact on the bottom line.

Today social responsibility is an issue in taxation. Professional accountants, who have always prided themselves on considering the public interest in addition to the needs of their clients, also need to accept that being seen to participate in or promote such "unfair" tax planning could harm their reputation in the long term. Above all, the professional accountants must continue to be forthright in their condemnation of tax evasion so that the general public is left in no doubt that tax evasion is not acceptable.

Views from Stakeholders - Summaries

FEE has asked a variety of stakeholders for their views on the future of tax policy. We are very grateful for all the contributions we received; the summaries of these articles are provided below, with links to the full articles. The debate is ongoing - check for new articles at http://bit.ly/FEEtaxpolicydebate.

Each of the articles in this publication represents the views of the authors. Unless specifically stated, their views do not necessarily reflect the views of the organisations with which the authors are associated. In addition, the views expressed in each article do not represent the views of the authors of other articles in this publication.

Business and the public finances: reflections, evidence and ways forward

Ian Young is international tax manager at the Institute of Chartered Accountants in England and Wales.

While many protest loudly about contemporary tax planning practices, a more considered approach reveals a more nuanced reality; one where major changes to our tax regimes have been underway for some time. This article notes the differing requirements of individual states when it comes to taxation, the realities of a globalised value chain and the changing nature of tax treaties. Such agreements have moved from concerns about double taxation to double non-taxation. It also sheds light on how widening the corporate tax base can compensate for lower tax revenues on profits and it notes that while the recent pace of change has been very fast, the political will that is driving effective cooperation between tax authorities around the world will continue given the parlous state of public finances in many countries.

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The morality of goose plucking

Joseph Stead is Christian Aid's Senior Economic Justice Adviser, primarily focusing on the relationship between tax and development and the related EU and UK policy.

What is the point of a tax system? This article gets to the nub of that question by raising some hard truths about human nature. While it appears that almost everyone accepts we need change, the technical and legal solutions proposed can only ever address the symptoms of aggressive tax avoidance and tax evasion. As long as the tax system is perceived as a way for government to squeeze as much revenue as possible from people and companies, those who have the resources will fight to minimise their tax burden. To deliver a better long-term solution we need to think a bit harder about the purpose of our tax systems. The challenge is to re-establish the clear link between taxes and the realisation of the common good of civilisation. The article posits that we need to change the relationship between tax and society at the individual, local, national and global levels and make it a conscious part of how we develop sustainable societies.

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Second-best regulatory solutions to the problem of corporate tax avoidance and evasion

Ronen Palan is professor of International Political Economy at City University London.

The problem of corporate tax avoidance and evasion remains intractable because of an uncompromising desire to protect sovereign rights. In the popular debate the invisible boundary that separates acceptable techniques from aggressive tax avoidance is clouded by a fundamental misunderstanding. People imagine multinational firms as some kind of single, unified legal entity. The article provides an eye-opening account of how corporate tax minimisation schemes make full use of multi-jurisdictional tax arbitrage. It also highlights Apple's tax arrangements as an illustrative example of the distinction between firm and corporation. Baring a complete change in the law of nations; one that would enable the creation of a true international firm, we had better get used to second-best solutions to the well-known problem of tax arbitrage.

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Tax avoidance: the missing link in business & human rights?

Mauricio Lazala is Deputy Director at Business & Human Rights Resource Centre, based in London.

This hard-hitting article frames aggressive corporate tax avoidance in a human rights context. In recent times much has been written about allegations of large-scale tax evasion by corporations. The deliberate use of loopholes, tax havens and a lack of government regulation, mean that societies, in both developed and developing nations, are being deprived of billions of dollars in taxes.

Many NGOs now contend that such practices deprive developing countries in particular of the resources necessary to deliver human rights to their populations. The article considers the influence of the UN's Guiding Principles on Business and Human Rights before highlighting some companies who are voluntarily choosing to disclose the tax and royalties they pay in each country.

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International taxation challenges

Bill Dodwell LL.B, LL.M CTA (Fellow) ACA leads Deloitte UK's Tax Policy Group, which manages tax knowledge, training, and consultations with the OECD, HM Treasury and HM Revenue & Customs.

In a globalised world are national governments powerless in their attempts to collect a fair share of tax on the value generated within their borders? Far from it notes this article. Whilst public anger about aggressive tax planning and outright tax evasion grows, significant steps have already been taken that may well drive a greater alignment between taxable profits and people-based activities in the future. Digitisation of tax compliance systems is the lever that tax authorities are using to break down offshore secrecy. International developments, such as FATCA, the Common Reporting Standard and work on the OECD's Base Erosion and Profit Shifting, signal that we are in transition to a new tax system, with all the systems challenges that entails.

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Not there yet: Despite strides, Europe still has work to do on financial transparency

A joint contribution by The Financial Transparency Coalition (FTC)

The **Financial Transparency Coalition** is a global network of more than 150 allied civil society organizations, fourteen governments, and dozens of the world's foremost experts on illicit financial flows. Porter McConnell is the Director of the FTC.

Corporate tax evasion is part of a darker problem. A problem that can only be solved by the light of financial transparency. This article examines the recent furore about Luxembourg's secret tax arrangements with more than 350 multinational corporations and links it to a wider policy issue. With momentum now building behind efforts to increase financial transparency in the EU can the Anti-Money Laundering Directive be the game-changer that puts beneficial ownership information, that is information on who ultimately owns or controls a company, into the public domain? Such information is key to tracking a whole host of criminal activities, from human and drug trafficking to state embezzlement and corporate tax evasion.

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Answering key questions of tax policy

Tetiana Iefymenko is President of the State educational and scientific institution "Academy of Financial Management", which, under the Ministry of Finance of Ukraine, brings together the best national scientists in economics and finance.

An overview of the role of tax policy and in particular the concept of fairness for a national economy. This article notes that the essence of taxation is constantly changing in response to socio-economic demands and technological progress. International tax competition is a fact of life. So rather than decry it, regulators need to factor it into their policymaking. A more important consideration is ensuring justice within the tax system. Taxpayers need to believe that the tax burden is fairly shared. Only then can tax policy be effective in delivering on a range of policy goals, be it stimulating growth or protecting the environment.

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Tax avoidance and international tax competition: a serious long-term threat to the welfare state and democracy

Achim Truger is a Professor of Economics at the Berlin School of Economics and Law.

As the inescapable logic of tax avoidance is played out in our economies there is growing awareness of its potentially destructive effects on the welfare state, on long-term economic potential and – in the end – on democracy itself. This article traces the ever decreasing statutory tax rates on top personal, corporate and capital income in nearly all OECD countries since the 1980s. It reaches a startling conclusion. Tax avoidance is not merely some kind of technically smart arbitrage between inconsistent tax laws; it is perhaps the most important driver of international tax competition. The article concludes that it is time for tax professionals to take a stand and to contribute to the design of an international tax system that better suits the revenue-raising and distributive needs of our welfare states and democratic societies.

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A fair tax policy is good economics

Tony Greenham and Helen Kersley - New Economics Foundation

Tony Greenham leads work into reform of the financial system. He is a chartered accountant and former investment banker, and author of many publications on finance and business.

A fair tax policy is critical to Europe's social and economic future. The stakes are that high, according to this thought-provoking summary based on the conclusions of a roundtable of European experts convened by the New Economics Foundation. It posits that a more equal distribution of income and wealth is a precondition of economic success. Thus it recommends that tax policy be used as part of an overall strategy to reduce excessive economic inequality. As Europe has witnessed recently, such inequality creates recessionary pressure by undermining consumption. Policy priorities are identified that could make the tax system more progressive, fair and unavoidable.

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The role of tax administrations in the current political climate

Jeffrey Owens is the Director of the WU Global Tax Policy Centre at the Institute for Austrian and International Tax Law, WU (Vienna University of Economics and Business).

Despite the current focus on adopting a tougher stance on tax enforcement, the author argues that effective tax compliance will only be achieved if is it is combined with good taxpayer service and where there is a constructive and transparent dialogue between tax authorities, taxpayers and their advisors. The article examines four related issues: the change in attitudes to tax compliance by tax administrations; how tax administrations are responding to the fast-paced challenges of globalisation; the new challenges tax administrations are facing; and the role and limits of international cooperation.

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Financial institutions in international tax compliance

Roger Kaiser is Senior Policy Adviser at the European Banking Federation (EBF) He represents European banks in a number of international expert groups.

This article provides a comprehensive overview of the role of financial institutions in the battle against tax avoidance. At the behest of tax authorities, European banks are playing an increasing role as tax intermediaries; one that involves the collection of withholding taxes and the systematic disclosure of information about investors. The new Common Reporting Standard and the Review Directive on Administrative Cooperation will only accelerate this process. In order to meet the exacting implementation timeline, Europe's banks are thus obliged to make significant investments in upgrading their systems. The article highlights some implementation challenges and questions whether these efforts and the introduction of increasingly demanding tax compliance requirements are the right approach to combat tax fraud and whether they are economically sustainable in the long run.

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Measures against harmful tax competition in Turkey

Semih Öz is a professor at the Political Sciences Faculty of Ankara University and head of the Public Finance Theory department and an adviser for TÜRMOB.

This article provides a case study of the measures Turkey has taken to combat harmful tax competition. Governments can defend their sovereign fiscal rights by enhancing their legislative armoury. To counteract harmful tax competition, however, information sharing with other governments is necessary. The article examines Turkey's approach, noting the impact of the Corporate Income Tax Law, which introduced defensive measures such as controlled foreign company regulations and transfer pricing provisions. It also summarises Turkey's international engagement with other tax authorities.

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Belgium's response to aggressive tax planning: state of play

Pierre-François Coppens is a tax and legal advisor and has joined the research department of the Institute of Accountants and Tax Advisors of Belgium.

This case study eloquently makes the point that the taxpayers' freedom to choose goes hand-in-hand with tax compliance. The article traces how Belgium, a relatively high-tax jurisdiction, seeks to battle the variety of ways in which individuals and corporations evade tax. The tax authority is now impressively armed and international cooperation is on the increase. But the complexity of the tax law can undermine the objective of increasing compliance. The solution? A new tax contract between citizens and the state, whereby compliance rises as the system becomes more clear, fair and efficient.

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Why the first World Tax Summit must take place in July 2015

A joint contribution by Oxfam International

Oxfam International's European Union office in Brussels works to influence key decision-makers to ensure that EU policies affecting poor countries have a far reaching, positive impact on the lives of those most in need. Winnie Byanyima is Executive Director of Oxfam International.

At a time of widespread budget austerity a series of recent tax scandals may provide momentum to calls to overhaul the fiscal architecture and find new solutions to fight against what this article terms tax dodging, i.e. legal or illegal tricks by individuals and companies to minimise their tax bill. Developing countries are vocal about the need for fairer international tax rules and for multinationals to pay a fair share of taxes where they exercise real economic activity. However such countries have been largely excluded from the underwhelming global response - the OECD's Base Erosion and Profit Shifting (BEPS) action plan. As 2015 will see the final negotiation of the UN's new Sustainable Development Goals (SDGs), the article calls for the organisation of a World Tax Summit to coincide with the negotiations. Public perceptions of taxation are changing and the European Union could play a leading role in ensuring that tax policy helps to build a more equal and socially responsible society.

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The European Commission's role in fighting tax evasion and avoidance

Heinz Zourek is Director General in the European Commission's Directorate General on Taxes and Customers Union (DG TAXUD).

The onset of the financial crisis has signalled the end of tacit societal acceptance of tax avoidance. While national governments crack down hard, in a global economy unilateral solutions are unlikely to be sufficient. This article examines the role of the European Commission in the fight against tax evasion and aggressive tax avoidance. It examines Europe's contribution to the international effort, notably the OECD's BEPS project. It also details the Commission's recent action plan that sets out 34 ways to enhance administrative cooperation, support the development of the existing good governance policy, tackle the wider issues of interaction with tax havens and aggressive tax planning and so on. The Code of Conduct group is also proving to be very effective in both identifying and eliminating harmful tax measures that can distort competition in the EU Single Market.

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Working together for better EU tax governance

Miguel Silva Pinto is the Deputy Director-General responsible for VAT in the Portuguese Tax Administration since late 2011.

What relevance does Europe's attempt to address its democratic deficit have for tax governance? A lot more than you might think. This article outlines a marked trend of EU governance to create mechanisms that open dialogue and bring civil society representatives more closely into the policymaking process. This reaching out implies more actors in policymaking, as well as the need for more transparency about who is contributing to the proposals. The traditional tax governance model is not immune to this trend and future VAT measures such as recommendations, guidelines or best practises are already being influenced by this desire for broader consultation.

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Automatic exchange of tax information

Johanna Hellström is a Senior Advisor with the European Savings and Retail Banking Group (ESBG) where she focuses on the areas of financial and prudential reporting and taxation.

If the automatic cross-border exchange of tax information sounds great in principle, implementing it in practice will be a major challenge. As this article notes, financial institutions are very much in the frontline. The timelines for implementation of FATCA and the OECD's Common Reporting Standard (CRS) are testing and the client due diligence and reporting requirements are extensive. The result is increased pressure, both on operational and technical resources, for the participating countries' financial institutions. Whilst the common goal is to reduce tax evasion and tax avoidance financial institutions must not be put in a position of being expected to risk breaking data protection rules. Ultimately, clear and harmonised rules need to be applicable worldwide.

► Read the full article

What to tax: time to shift tax systems from 'goods' to 'bads'?

Fabian Zuleeg is Chief Executive and Chief Economist of the European Policy Centre (EPC). His research focuses on the economic and Euro crises.

As Europe struggles to get its economy back on track, new taxes are very much on the political menu. Fiscal consolidation in a low growth environment is key to finding a better balance between spending and revenue in the longer term. As overenthusiastic public expenditure cutting can create a downward economic spiral, the desired balance cannot be delivered by cuts alone; taxation will also have to deliver greater revenues. This article highlights potential sources of taxation which have not been fully exploited and which can have a positive effect beyond revenue-raising including taxes on speculation, on the causes of climate change or on products that might harm health. It also notes the Single Market implications of broadening the tax base.

► Read the full article

Assessing the impact of the flat rate tax reform and the introduction of targeted tax relief in Hungary

Ádám Balog is Deputy Governor of the Magyar Nemzeti Bank and member of the Monetary Council. **Gergely Baksay** is Head of Fiscal Analysis Directorate at Magyar Nemzeti Bank. **Balázs Csomós** is Head of Fiscal Analysis Department at Magyar Nemzeti Bank.

A case study from Hungary on how income tax reform impacts the labour market. Finding the optimal income tax regime remains an elusive goal for governments around the world. This paper provides an in-depth analysis of recent changes to the Hungarian tax system. It predicts the long-term macroeconomic, budgetary and labour market effects of the introduction of a flat rate personal income tax system and the use of targeted tax relief for specific sections of the labour market.

► Read the full article

The role of IT in tackling tax evasion and aggressive tax avoidance

Dieter Kempf is Chairman of the Managing Board of DATEV eG and President of the Federal Association for Information Technology, Telecommunications and New Media e.V. (BITKOM). **Silke Stein** is personal Assistant to the Chairman of the Board of DATEV eG.

Information Technology (IT) can play a much greater role in detecting and preventing tax fraud or aggressive tax avoidance. This broad-ranging article firstly considers the subjective aspect of fair taxation and the latest international efforts to clamp down on unwanted behaviour, notably through the OECD's Action Plan on BEPS. It then delves into the power of IT and explains how it can deliver the data needed to react, either by using intelligent retrospective or predictive data analysis, or by effectively increasing transparency. The roles of statistical and psychological techniques, as well as forensic tax accounting, are also examined. In conclusion, it is noted that IT is simply a tool. And one that may even be a precondition for some tax avoidance strategies. However, aggressive tax planning or avoidance is more often driven by tax competition between individual states.

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Tax policy as a matter of good governance

A joint contribution by Giovanni Bracco, Simon Perry, Richard Chadwick and Ray Farnan

The contribution "Tax Policy as a Matter of Good Governance" has been provided by PwC. The contribution has been mainly prepared by **Richard Chadwick** who is a UK partner in PwC's Tax Risk Assurance team.

A changing tax environment necessarily requires adaptation. For leading corporations, good tax governance is no longer considered in isolation from overall business governance. In this article, tax is seen through the prism of risk management. As tax is very much a core business issue, a risk assurance framework can help a corporation manage risk and put in place adequate controls. A rigorous approach improves assessment and limits risk.

► Read the full article

The search for a tax ethic

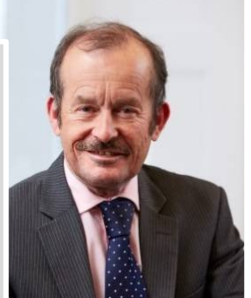
Richard Baron is a philosopher who lives and works in London. He has also worked as an adviser on tax policy, both for the British Government and for the Institute of Directors.

Does your company pay its fair share of tax? In answering such a clearly subjective question, the actual amount paid is not the most relevant factor. A robust tax ethic provides an overall approach to tax planning and guides decision-making. And it means that when challenged, you can justify your approach. This article delves into what a tax ethic can achieve for a corporation and provides some sources of inspiration. Having established what a corporate tax ethic look like it then derives one for professional tax advisers.

► Read the full article

Views from Stakeholders – Full articles

Business and the public finances: reflections, evidence and ways forward



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He also works with the UN and OECD. He chairs the UK government's Taxpayer Charter Committee which monitors the work of HM Revenue & Customs in this area and is currently conducting a strategic review of the Charter five years after its introduction in 2009.

Making tax systems work in the 21st century

Why are we having this debate?

Tax is now making the headlines in a lot of countries round the world and not for the best of reasons.

Wealthy individuals are accused of hiding their money in tax havens and paying little or no tax in the countries where they are resident and multinational business is accused of arranging their global operations to pay less tax in many of the countries in which they operate.

Governments face a crisis in their public finances and the general public has now got an appetite for revelations about tax shenanigans, which they didn't have only a few years ago. And bodies like the Public Accounts Committee in the UK and the US Senate Permanent Subcommittee on Investigations are adding weight to the tax scandal stories appearing regularly in the world's press.

International organisations such as the G20 and OECD, and the European Commission, are adding their own weight to those who believe that something needs to be done and OECD is in second of two years of work on Base Erosion and Profit Shifting at the behest of the G20, which it hopes will sort out some of the worst excesses of the current system. The European Commission is on a parallel track with its own action plan to strengthen the fight against tax fraud and tax evasion, which it launched in December 2012.

There are also moves afoot in the US, the European Union and OECD to introduce global standards of automatic exchange of information, which follows on from the abandonment of bank secrecy.

Will all these efforts be enough?

There is a lot of noise in the debate but there is, at the moment, often an absence of light.

The role of taxation

Oliver Wendell Holmes who was a Judge in the United States Supreme Court for nearly 30 years at the beginning of the 20th century, famously said: "Tax is the price we pay to be members of a civilised society."

Clearly many of the things that we are able to achieve, on a societal basis would not be possible unless we pooled our resources and did things collectively: building hospitals and schools and providing the infrastructure on which we all depend. Put like that paying our taxes makes perfect sense.

But another key tenet of society has been that governments should not be allowed to appropriate the private goods of its citizens. The Convention on Human Rights, signed after the Second World War, and in particular its first protocol, set out that everyone should be free to enjoy their private possessions but that they could be deprived of some of these possessions if it was:

"... in the public interest and subject to the conditions provided for by law and by the general principles of international law."

So the general law is that we can enjoy what is ours unless there is an overriding legal provision which determines that what is ours can be used for a more general purpose. This is the post Second World War reworking of what Oliver Wendell Holmes had said at the beginning of the century.

These general principles have translated into a high profile and sometimes tetchy debate as to whether particular participants in society are making their fair and appropriate contribution to the communal good.

The debate has been moving to and fro for a long time but it has been given its current focus and piquancy as a result of a number of factors that have come together:

- the state of the public finances;
- the ability of civil society to galvanise opinion; and
- the more ethereal nature of current business which exploits the value of intellectual property across geographical divides rather than making mass-produced products from conveyor belts in factories situated in a particular location.

What should the state be responsible for?

Tax is designed to fund public expenditures and the activity of the state. If the state occupies a smaller part of the economy then that particular economy will require fewer taxes. The size of the state varies from about 20% in Singapore, 30% in the United States, 40% in the UK to more than 50% in France and even higher than that in some of the Scandinavian countries.

Clearly the tax system has to do more heavy lifting in the latter than in the former countries.

The amount of tax that particular sectors of the economy are required to pay will be dependent, to some extent, on the amount of tax that the economy requires to sustain its societal model.

Globalisation

It has been particularly the case in recent times, and certainly during the 21st century, that business is no longer located in particular geographical areas nor does it organise its business by reference to such areas. There will often be particular business lines that are organised across the globe with little need to be concerned by geographical boundaries. It is also true that a larger proportion of the increasing international trade is carried out within related

businesses, between groups of companies which are in the position to organise their internal terms of trade such that profits are more likely to end up in lower taxed parts of the world. Estimates vary but as much as 50% of world trade is considered to take place between related businesses, within for instance groups of companies.

Treaties between countries to avoid double taxation

The League of Nations became concerned, as early as 1921, that businesses that were conducting their activities in more than one country could, if there were not suitable safeguards, end up paying tax in more than one jurisdiction on the same profit. The work of the League of Nations led to the drawing up of the Model Tax Conventions of Mexico (1943) and London (1946) but neither of these conventions were fully or unanimously accepted and in 1956, in the absence of further work by the United Nations, the predecessor of OECD, the Organisation for European Economic Co-operation (OEEC) established a Fiscal Committee which led to the Draft Double Taxation Convention on Income and Capital that the OECD adopted in 1963. Further work led to the publication of a new Model Convention in 1977 and in 1991 this became an ambulatory Model Convention as updating and upgrading was by now recognised to be a continuous task. The aim of these conventions was to minimise the risk of double taxation.

The United Nations itself published its own Model Double Taxation Convention between Developed and Developing Countries in 1980 with new versions published in 2001 and 2012. The United Nations model follows the basic principles of the OECD model but it gives more taxing rights to source countries, where investments and business are carried out, as these are likely to be in the developing world.

Is double non-taxation now the problem?

The double tax conventions were designed to prevent double taxation and the UN model was, in addition, designed to protect the economic interests of countries in the developing world. In more recent times business has been able to exploit the disconnects between the international tax rules and domestic tax systems to reduce the amount of tax it has had to pay. Hence the work which is now being undertaken and which is discussed in the next section.

What is being done to correct the international tax arrangements?

The European Union launched an Action Plan in December 2012 to strengthen the fight against tax fraud and tax evasion and the OECD began its Base Erosion and Profit Shifting Action Plan in July 2013: which was endorsed by the G20 countries at their Summit in St Petersburg in September 2013.

The OECD work has a higher profile, a tighter timetable and the explicit backing of all OECD countries, 34 in total, and the G20 countries that are not OECD members, 8 further countries including all the BRIC countries Brazil, Russia, India and China. Since the beginning of 2015, 14 countries from the developing world have also joined this G20/OECD work. These countries account for about 85% of the world's economy so they are powerful backers.

The timetable is pretty tight and, for the 15 actions identified in the plan, the necessary changes need to be in place, or decided upon, by the end of 2015 and be endorsed at that time by the G20.

It is not entirely clear what will be achievable or how iconoclastic the changes will be. There will

undoubtedly be some 'pushback' when individual countries have to decide on the changes to their own domestic regimes, required by international agreement, but not necessarily in their own domestic best interests.

How much tax does business really pay?

The public debate has concentrated on the amount of corporate income tax that companies pay on their profits because those are the two numbers that appear clearly in their published accounts which are available for all to see. The problem has been that the rise of service industries, the increasing relevance of intellectual property in creating value and the ability of business to choose where it conducts its business has severed the clear connection between business activity and a specific geographic location. Business is peripatetic: it can be done anywhere and it is increasingly difficult to pin down where the profitable bit of the business is actually located.

The old adage of Jean Baptiste Colbert, the Finance Minister of Louis XIV in the 18th century has become increasingly apposite:

"The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing."

Governments have increasingly sought to tax many different parts of the economy and have many different taxes for any single part. So business does not merely pay tax on its profits but also pays charges in respect of the people it employs, in the UK this is employers' National Insurance Contributions (NIC). The other main taxes paid by business in the UK are irrecoverable VAT paid by the financial services sector and taxes on property. PwC, the professional services firm, has carried out a survey each year for the past ten years to determine how much tax is paid by the largest UK companies and it now finds that for every pound of tax that is paid on profits there is a further three pounds of other taxes that business has to pay. When the surveys began the other taxes were of the same magnitude as the taxes on profits, so for every pound paid on profits there was another pound paid on other income or activities.

This does not mean that we shouldn't continue to be concerned about the tax that companies pay on their profits but it should make us aware that the overall position is a little more complicated. Not least because of the difficulty of working out where profits are actually made governments are looking to tax companies by other means and the evidence from the UK is that they are succeeding.

Economists argue that companies don't ultimately bear the cost of most taxes because they adjust their business model and, for instance, compensate for any extra taxes by cutting back on, for instance, employee wages. Clearly if one cost goes up a business is going to need to adjust by cutting other costs or increasing revenues if the business profit is to be maintained at the same level. But it does seem to me that the taxes that PwC have calculated that companies pay are all genuine costs to the business as is the tax they pay on their profits.

Business is also a tax collector in many countries and the PwC UK survey shows that for every pound of tax that is paid there is almost GBP 2.50 of other taxes collected on behalf of government.

Evasion by wealthy individuals

Another concern mentioned at the beginning of this article was that wealthy individuals are hiding their money in tax havens and paying little or no tax in the countries where they are resident. This may well amount to tax evasion, which is illegal, and is certainly not something that anyone can condone.

There are various current efforts, from the United States and OECD, to try and make sure that fiscal authorities get the required information about financial accounts so that they can make sure that people resident in their countries are paying the right amount of tax.

The United States has taken action in relation to its own citizens by introducing FATCA (Foreign Account Tax Compliance Act) in 2010 which has ended up requiring other countries to set up arrangements so that they can capture information about investors in their own financial institutions which have links with the US and the relevant details can be reported back to the US. This process went live in July 2014 but reports won't be required for a year or two.

This system is also going worldwide with the OECD introducing its own Common Reporting Standard: this new system was set out in a document published in February 2014. This will require automatic exchange of financial account information between all the countries that sign up to it and although there is no formal timetable there are a number of early adopter countries. It will come in within the next couple of years.

The OECD also has a Forum on Transparency and Exchange of Information which is overseeing these and other developments and which has more than 120 member countries involved, considerably more than the 34 full-time member countries of OECD itself.

The intention is that these information exchange arrangements will cover all the countries where individuals can deposit their monies, or have investments, and any resultant income will be reported back to the country where they are resident and should be paying their taxes.

The future

The above clearly demonstrates that there are currently a number of significant international developments in train designed to make sure that companies pay a reasonable amount of tax on their profits and that wealthy individuals, and others, can't put their financial wealth in parts of the world and escape tax on the resultant income.

The pace of recent change has been enormous and the major developments have all taken place since the financial crisis erupted in 2008. The speed and significance of the changes has been the result of the political will that has driven the developments and the continuing parlous state of the public finances in many countries has meant that governments can't afford not to keep up the pressure on these initiatives. There is going to be a continuing need for bolster the public finances for the foreseeable future so the political imperatives will remain unchanged: the tax world is going to be in a state of flux for some time to come.

The morality of goose plucking

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He comes from the UK civil service where he worked for both the Foreign and Home Office and among other things he worked on African economics, trade and development policy and asylum and immigration law. He has an MSc in African Politics from SOAS and is also co-chair of the board for the Jubilee Debt Campaign.

Tax and Morality

Over the last few years, whichever way you turn there is evidence that something has gone wrong with tax. Be it that internet and technology giants are on a curious diet of "Dutch Sandwiches" and "Double Irishes", or that developing countries lose to tax havens more than three times what they receive in aid, there are new stories almost every day adding to the general sense that across the world that tax is not working.

From political leaders, opinion polls, and even from business leaders, there is agreement that tax systems need to change. Perhaps even more specifically, there is wide agreement that the way we tax corporations, and especially multinational corporations, should change.

What is not clear though is what that change should look like. Just as we are bombarded with evidence that something is wrong, we are presented with multiple recommendations on what is to be done (some of them from Christian Aid). These can range from minor tweaks here and there to the creation of a world tax authority or abolition of corporation tax. But almost invariably, no matter how the recommendation was framed, any discussion very quickly turns in one, or more, of three ways.

The first is that it gets very technical, very quickly. Detailed questions on implementation of an idea are produced and anything short of a perfect answer is claimed as evidence of the naivety or impracticality of the proposal, or the proposer themselves, or often both. This can put many off engaging in the debate, including those from developing countries.

Many developing countries lack capacity around tax, in terms of both policy and administration. In pure numbers, Sub-Saharan Africa would need to find 650,000 more tax officials to meet the world average ratio. Yet while capacity may be limited, the integration of developing countries into the international tax system is not.

All countries are expected to negotiate contracts and tax treaties, apply the OECD's arms' length principle, as well as broaden their tax base and formalise their economies. For poorer countries, this leaves little technical capacity to spare. So if there is a high technical barrier to entry, many developing countries are likely to be excluded

from important opportunities to increase their tax base.

Similarly insisting on technical expertise as a barrier to entry restricts those who can be part of the discussions on reform. This is not to say that technical expertise is not needed, in such discussions. It clearly is. But too often, discussions on tax can turn to the technical too quickly, and the ideas and principles behind recommendations get obscured by detail.

The second way discussions about tax reform may turn is to become legal. This can overlap with the technical, as the details of how proposals would be legislated for may be demanded. Loopholes can be cited as evidence, again, of naivety or impracticality, even where there are fewer loopholes in the new proposals than there are in the original regulations to be replaced. Where recommendations do not involve new laws, the legal argument may be based on the view that you can only expect companies to comply with the law and nothing more. Expecting voluntary action by companies on tax is not seen as acceptable.

Again, this can leave developing countries with a problem for a number of reasons (including capacity and often challenging legislative processes). Developing countries have much less advanced tax laws than developed countries. This may leave loopholes in their tax regime that have been long since closed elsewhere. Both capacity constraints and corruption can also mean that well-resourced companies (and individuals) are able to negotiate very favourable contracts, influence tax policy, or make investigations go away.

While corruption, of course, is illegal, if the corruption is not known then the final outcomes will be viewed as legal. Indeed, even when the outcomes are found to be the result of corruption it may not always lead to the laws, contracts or treaties being struck down or reviewed. However all these outcomes can also be the result of the gulf in resources between developing countries, multinational corporations and developed countries. The result is legal, but it also leads to a clearly disadvantageous situation for developing countries, that many would regard as unfair.

While laws are vital, and getting them right, and getting everyone to follow them is necessary, there are questions as to how far it is right and even possible to solve everything through legislation alone. In many areas of life, behaviour is bounded not only by the law, but also by a mixture of conventions, convictions, morals and other impetus. It appears unclear why these should not also apply to tax behaviour.

The third main way in which discussions may turn is to become personal. While tax reform recommendations might be looking at the impact on societies as a whole, the discussions will very quickly turn to short-term impacts on individuals and individual companies. It is very difficult to encourage people to think beyond the impact upon themselves or the companies they work for. Whilst this impulse is understandable, it is also problematic. Women are likely to be absent or under-represented in tax discussions, which may partly explain why the gender impact of tax systems is so little assessed. When such assessments are done the evidence shows tax policy is not gender neutral, and women are often systematically disadvantaged, especially where gender inequality is already high.

Tax policy is not development neutral either, and for developing countries which are often not represented in international discussions. It's problematic because it means there is usually no-one fully representing their viewpoint and considering the impact recommendations will have on developing countries and the people living there.

By reducing discussions about tax to the technical, legal or personal, what appears to be missing is the bigger picture: the role of tax in society. Louis IX's finance minister, Jean-Baptiste Colbert famously said that, "the art of taxation consists of plucking the goose so as to obtain the largest possible amount of feathers with the smallest amount of hissing." Whilst trying to raise as much money as possible without anyone noticing might have been the best approach for an absolute monarch in the 17th or 18th century it may no longer be the right approach today.

While a technical and legal approach may be deemed to fulfil Colbert's maxim, the primacy of individual self-interest for many shows that in the current framework, given a chance, people will hiss if they think a tax policy will lead to them paying more tax. And some can hiss louder than others, thanks to their financial and political power.

This leads, almost inevitably, to a race to the bottom. The only way to reduce the hissing is assumed to be a lowering of taxes. But this is clearly unsustainable in the long-run and illustrated most sharply in developing countries.

Many of them, especially low-income countries, have very low tax to GDP ratios - typically below 15% (the OECD average is over 30%). The minimum level needed to be able to reach the Millennium Development Goals is estimated to be 20%. Developing countries, with a need to develop both physical and human infrastructure and capital, need to raise more revenue. While formalising the informal economy can bring some gains, much of the informal economy is also excluded from GDP figures, so formalising the economy may not shift the ratio much, if it all. Developing countries need to do more than just tax the informal sector. But in a world that is racing to the bottom in terms of taxation, it's unclear where those revenues will come from. In Sub-Saharan Africa many of the special economic zones, designed to encourage foreign direct investment, have tax rates close to zero.

Is there an alternative way to reduce the hissing? Most are likely to object to a complex system designed to take as much tax from them as possible, ideally without them noticing. If there are loopholes and escape routes - using tax havens and other means - then many will seek to use them.

Yet while this may describe the tax system we actually have, it's not the only way, and indeed it is not how many people conceive of the tax system, at least in principle. US Supreme Court Judge Oliver Wendell Holmes Jr, famously said: "I like to pay taxes, with them I buy civilisation," showing the clear link between taxes and the realisation of the common good of civilisation.

This link between tax and the common good is something Christian Aid has studied closely, and we recently produced the publication *Tax for the Common Good: A study of tax and morality*. While the publication looked at issues of tax and morality from primarily a theological perspective, the questions it raises are worthy of consideration by people of all faiths and none.

Through the paper comes a clear articulation of a tax system that need not require ever lower taxes to reduce the level of hissing. Perhaps the main message is that the common good of society does not just happen. "It's not an abstract idea or thing whose substance may be defined, but a set of responsibilities pertaining to a shared project of which all are part," writes Esther Reed in the publication.

We cannot sit apart from the societies of which we are a member, and we all have an obligation towards all within our society. Paying taxes is not our only duty, but it is one of them. The extent to which goods and services in any given society will be publicly or privately provided is a matter for each society to determine, and so its attendant tax needs.

However at the minimum is the need for a robust and accountable state, which helps maintain a social structure in which individuals can live together with civility, dignity and mutual respect. And this need alone creates a need for those who can afford it to pay taxes. This need alone also makes us recognise that tax (and other societal duties) are about more than the costs and benefits to us as individuals. Taxes also have an impact on society as a whole.

It is far too easy to be distracted or blind to the abuse of power. It is common for people to see business as existing solely to make as much profit as possible, and use that as a justification for avoiding as much tax as possible. But just as the purpose of governments should not be to raise as much tax revenue as possible – their role is to help create and maintain a flourishing society for all - so businesses should also have a role in creating the good society. Profits are necessary for businesses to sustain their role, just as taxes as necessary for government to sustain theirs, but in neither case should they be their reason for existence. To lose sight of this fact risks abuse of power and undermining the tax system.

Protecting against this abuse of power and challenging it when it occurs, requires a variety of approaches.

It starts with individuals, who need to make a conscious effort to be more aware. Not just of the power they have and the decisions they make, but also of the context they, and their decisions, exist in. It takes an effort for those (be they businessmen and women, politicians, officials, journalists or others) sitting in offices in London, Paris, New York and (increasingly) Beijing and Hong Kong, to contemplate the impact of the decisions they are making or influencing on others, especially those in poverty in faraway countries.

It will not necessarily be easy for individuals, even when acting more consciously, to effect change. Many of the processes, structures and incentives in many areas, including tax, are not set up to encourage challenge. Broader debates and discussions, leading to coordinated action, across businesses, governments, parliaments and societies will be needed. There are signs that this may be beginning to happen.

The growth of the Fair Tax Mark in the UK (a label for good taxpayers), which has both SMEs and large companies now amongst those receiving the Mark, is beginning to generate a debate about both the role of tax in how companies are viewed, as well as the ways in which companies tax affairs can be communicated, understood, and assessed by the public. Ireland (at the time of writing) is undertaking a spillover analysis of the impact of the Irish tax system on developing countries. Its conclusions should help advance the debate on the duties and responsibilities of a country for the impact its tax systems may have on others, especially developing countries. The Netherlands is reviewing its tax treaties with developing countries following its own spillover analysis on its treaty network. Investors are increasingly asking questions on tax practices of the companies they invest in and the Co-operative Bank in the UK has just announced that tax practices will form part of the criteria for its ethical lending.

To go further in these debates though more will be needed. Alongside individuals being more aware and taking more responsibility, we will also need concerted action to create greater transparency; to allow a greater understanding and assessment of how our tax systems are working (or not working). This needs to apply to companies and governments alike.

More transparent company data and behaviour can not only help build trust in those companies that are compliant, and improve scrutiny of

those that seek to push the laws too far - it will also help develop a greater understanding of how different countries tax systems are working, and what impact changes in tax policy has on business activity. For developing countries especially, it may also help identify obvious loopholes in laws too.

Greater transparency by governments would also help identify both the costs and benefits of tax incentives and reliefs, allow meaningful debate on their utility and public pressure to drop any that are ineffective. Many developing countries forgo a significant proportion of their GDP in tax incentives (between 9%-16% in the Caribbean for example), yet there is no conclusive evidence that they are effective in stimulating development. Indeed much of the evidence is to the contrary and the IMF and OECD both suggest great caution in the use of tax incentives.

Similarly, greater transparency on the assets held offshore (e.g. through making Bank of International Settlements data public, or creating aggregated data of cross-country holdings from data collected through Automatic Exchange of Information) would help developing countries identify where to focus their attention as they integrate into global information exchange. It will also enable citizens to hold governments accountable on how effective and genuine their pursuit of offshore wealth (often held by powerful elites) is.

While some of this may sound somewhat utopian, it does also seem that it works. There is an increasing body of evidence showing that greater citizen engagement in tax and budget systems leads to reduced tax evasion, higher revenues and improved social outcomes. It does indeed seem that there is another way to reduce the hissing than to trying to keep tax as a technical and legal issue for a narrow section of society. By making tax a genuine part of the societal discourse, providing transparency, ensuring that individuals and governments take responsibility for the needs of society as a whole, it is possible to build trust and understanding between governments, businesses and citizens and to create tax systems that are not seen as a technical chore, a legal game where the rules can be pushed to the limits, or a personal cost to be minimised wherever possible. Instead it can be seen as a tool to help improve the societies we live in, work in, rely on and interact with.

Such an approach would provide a fundamental shift to the current nature of the debate, and associated actions, on tax. Rather than quickly becoming technical, the debates on tax would focus more on the principles and objectives of the tax system, involve a wider range of people, countries and stakeholders, all of whom recognise and consider the needs of and impacts on others. The technical details would then follow. While this may, in some cases, lead to a discovery that some things really are impossible for a tax system to do, more often than not it will become apparent that political will can energise technical solutions.

The legal nature of the debate would shift too, while compliance with the law would still remain the key criteria for all, the obligations to the law would sit within an understanding that the obligation to societies in which companies operate and individuals live go wider than the law. Currently we appear to be creating a vicious circle where the activities of some (sometimes many) in pushing laws to, and beyond, the limit, leads to more and more complicated laws, higher compliance costs and the new laws being pushed to the limits again. With a better shared understanding of the obligations to society, and greater transparency over activities of governments and companies, behaviour will change. Laws would be less likely to be pushed so hard, common standards and expectations of behaviour would develop and accountability on those expectations increase.

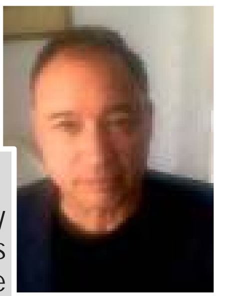
To return to Colbert's goose, the attempt wouldn't be to pluck a goose as much as possible without it noticing, but rather to build the consent to be plucked, by situating it as a necessary act in building a thriving and sustainable society.

Getting to such a stage will take time and effort. It will require changes both within and between countries, and leadership from those in a position to lead. But it is not impossible.

What is not possible is what is being attempted at the moment: to admit that our tax systems are not suitable for the modern globalised world, yet to seek to reform them by the same means by which we ended up with these unsuitable, unworkable, tax systems in the first place.

Changing our approach on the relationship between tax and society at the individual, local, national and global levels, to make it consciously part of the discussion on how we develop sustainable societies, is, it seems, the only possible way to get the reforms that almost everyone accepts we need.

Second-best regulatory solutions to the problem of corporate tax avoidance and evasion



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The writer, Doris Lessing once said, "There is only one real sin, and that is to persuade oneself that the second-best is anything but the second-best." I argue here that there is deep analytical confusion regarding the principles of tax mitigation techniques. Unfortunately, this confusion muddies the waters, preventing regulators, accountants and businesses, as well as NGOs, from seeing clearly that all politically practical solutions to the problem of corporate tax abuse are second-best; there is no point in pretending otherwise. Since the status quo ante is not even a second-best or remotely acceptable proposition, the likelihood of additional national and international measures against corporate tax avoidance in the near future is fairly high. Yet, a realistic discussion of the merits of the various proposals being tabled should acknowledge from the outset that none of them (or those still to be dreamed up in the future) are likely to resolve the problem. Our world of second-best solutions consists of a trial and error approach whereby a realistic assessment of success of any given measure may lead to the classification of some as second-best and others as not.

The analytical confusion about the nature of the tax mitigations techniques employed is good for no one for it marks the tax advice business with the dubious honour of being considered simultaneously legal (in principle, at least) and yet immoral. It places lawyers and accountants in an uncomfortable position whereby practicing the law (as they interpret it) implies doing something immoral (which many of them secretly believe they do); whereas doing something moral, may not in fact be, strictly speaking, in accordance with the letter of the law. It creates a grey area whereby lawyers and accountants are encouraged, or so they believe, to advise companies to act in the best interest of their shareholders. Advice that would suggest that their role is to construct business models that minimise the corporate tax footprint, ensuring higher returns for shareholders.

At the same time, they are being told not to try too hard, for to do so may cross some invisible boundary that separates acceptable tax avoidance techniques from aggressive tax avoidance – the former is fine, the latter is not. Who is in charge of that boundary? Normally, the tax authorities themselves, which are organisations subject to the whims of their political masters. The boundary also tends to shift with the size of the commission being paid,

the bigger it is, the more aggressive tax mitigation techniques are likely to be.

The resulting response to corporate tax avoidance, whereby most of the new regulations are centred on those states that are viewed as tax havens, is symptomatic of a second-best approach. The problem, I argue, lies elsewhere. It lies with the very nature of the corporation as a legal entity—and that is something that no one so far is prepared to tackle.

The legal theory of the firm

Theories (and accusations) of tax avoidance are both premised on the conventional view of the firm and of its responsibilities to shareholders and stakeholders. Jean-Phillipe Robé summarises succinctly this view. It is built, he says:

"around the notions of agency, property rights and contracts. The common view is that the shareholders are the owners of the firm and that the managers, as their agents, must manage the firm in their interest. Firms are assumed to be operating within perfect legal and political environments internalising all externalities within the firms' production prices. All interests affected by the firm's activities (other than those of the shareholders') are assumed to be adequately protected by contracts and laws. Maximising the shareholders' interests in the management of the firm is then presented as the only form of management to be socially beneficial," (Robé, 2011, 1).

Firms are viewed as utility maximising actors – not different in principle from individuals. When the media talks of Apple, Starbucks or Amazon, and accuses them of failing to pay their fair share of taxation, the media refers to a notion of a firm as described above, as a unified and unitary entity run by a CEO and a board of directors. Aware as they are of the importance of their brand names, these companies encourage that view.

The political debate surrounding tax avoidance and evasion tend to stress similarities between individuals and corporations in other ways as well. I often hear an argument to the effect that we are all guilty of tax avoidance and evasion. Only that we do so on a smaller scale. We pay the plumber in cash and avoid paying VAT, we ask our friends to bring in some duty-free goods. We sometime forget to declare some miscellaneous income (say, a sale through Ebay for instance). Why should corporations be different? After all, they are rational actors like all of us. Why should they be held by higher moral codes than all of us? Is it not the case that the scale of their operation is different, but in principle they are not different from all of us?

Well, not really.

There are very specific historical reasons why any firm or a bank that seeks to internationalise cannot be a unified legal entity as assumed in theory. The reason has to do with one of the core coding principles of the contemporary world, sovereignty.[1] States insist on full sovereignty over their territories. This means that all active economic actors that are located in their territories, whether they are physical persons or a corporate personalities (or indeed, every moveable object, including cars, airplanes, and ships and so on) must be licensed to operate in each and every territorial space they wish to operate. Corporations (or companies, different countries use different terminology to describe licensed corporate actors) are therefore legal entities that are licensed by the sovereign to operate within the boundary of a specific national space. Those that wish to operate in other countries as well must register as separate corporate entities in the territory in which they

[1] I discuss the sovereignty issue at length in my book (Palan, The Offshore World: Sovereign Markets, Virtual Places, and Nomad Millionaires., 2003)

wish to operate. That company will have to abide by local laws.

A UK registered company cannot simply trade in the US. Rather, if it wished to trade in the US (as opposed to selling its products to a US registered company) it is required to set up a US registered company in order to do so. The two companies may have close economic relationships between them; the UK company may fully or partially own the US company, and the income generated by the US company may flow fully or partially flow back to the UK company, but legally speaking, the two companies are separate entities. One company functions under the supervision, laws and taxation rules of the UK, the other under the supervision, laws and taxation rules of the US.

In light of the above, Robé proposes to distinguish among two concepts, the concept of the corporation and the concept of the firm. The corporation, he suggests, is a legal entity that is license to operate in a national space; the firm is not a legal entity but the economic logic that unites co-owned by legally separate corporations. Firms often control strings of legal entities or corporations – at times numbered in the thousands – and in that sense, they can operate in many jurisdictions or be seen as multinational corporations. But firms do not have a legal existence, only corporations do. In other words, legally speaking, there is no such thing as a multinational corporation or a multinational bank. These terms may refer to important economic and even political or social categories, but not to legal entities. [2]

[2] 'Corporations are apart among the legal instruments used to legally structure firms. The reason for this is that they are treated by the legal systems as if they were "real" persons (with some adaptations), i.e. they can participate in the legal systems through the phenomenon of "juridical personality". They can own property, have debts, contract, sue and be sued in courts, get bankrupt, etc. –i.e. they can "function" in the economy like human beings because they are treated by the legal system as if they were "persons" (Robé, 2011, 11).

The distinction is important, indeed, crucial to understand the principle upon which all known international corporate tax mitigation techniques are founded. They are all predicated on the legal differences between the location of the economic control of the firm, and the legal foundation of the corporations, which as we saw is territorially bound.

Now, here lies the confusion between legality and morality. The entities that make the headlines for supposedly failing to pay their taxation tend to be firms in Robé's terminology, not corporations. But these firms are not legal entities and, hence, strictly speaking they are not subject to laws and regulations, including taxation. Firms often respond to the accusations of tax avoidance arguing that the corporations under their control, the separate legal entities that are located in different jurisdictions, are paying their tax obligations to the full. Firms do not in fact file tax returns – although they may declare their annual profits and taxation to the stock exchanges in which they are trading (that is why, generally speaking, there is no link between profit declarations to the stock market and the tax returns).

When the public demands that firms (confused for corporations) pay their fair share to society, the public unknowingly demands that firms will ensure that the different corporate entities they own or control, will ensure they pay taxation based on a hypothetical case as if they were unified legal entities. But since firms do not exist as a legal subject, this demand is simply unenforceable. There is no imperative, legal or moral, felt by, say, a UK firm (as described in the scenario above), to try and ensure that the legal fiction of its separation into two companies, one located in the UK, the other in the US, is ignored, so that the firm will voluntarily reconstruct itself for tax and regulatory purposes as a unified actor and pay the taxation 'due' both in the UK and the US accordingly.

The demand for fair taxation turns out in reality to be no more than a plea for firms to act as good citizens and voluntarily ensure they pay tax as if they were a unified entity. What complicates matters is the idea that firms as economic units fully own the different branches and subsidiaries. Often they do not, they may part own some branches or subsidiaries which may or may not share the same name. I will not even attempt to discuss here the more sophisticated, but typical, forms of ownership structures, controls and various swap arrangements that make a mockery of any of the above ideas.

From the perspective of such firms as well as the armies of accountants and lawyers that advise them, the public outcry about fair taxation appears as nothing less than an unfair demand. Indeed, many accountants and lawyers believe that the public and the media unwittingly and unknowingly demand of them to act illegally, and advise companies to act against the best interest of their shareholders.

This analytical distinction may explain Starbucks' confused and confusing response to the PR disaster that surrounded the revelation of its UK tax affairs. In response to public anger, Starbucks offered to pay GBP 20 million pounds in 'taxation' to the UK. But the figure appeared to have been plucked from thin air. It did not look like taxation all, but more like a voluntary contribution or a donation to the UK purse, aimed at placating an angry public.

If we continue with the common trend of treating firms as individuals, then the demand that we are now making of firms (and the perception at Starbucks of the pressure they were under) could be described as the equivalent of individuals opting for the red channel in the airport and demanding to pay VAT on their duty-free, saying to the custom officers, "I know that your country allows me to bring in these goods duty-free, but I happen to think that your laws are a mess and I would like to pay tax." If that person is like Starbucks s/he might even pull out say, a five-pound note and leave it with the custom officer as a token of their belief that some tax must be paid.

This is only one side of the equation in the mess created by confusing firms for corporations. From the perspective of states, there is no particular reason for either the UK or the US to try and synchronise their laws, regulation and taxation principles with each other, or even to exchange information about the two companies in the scenario above so that they could somehow treat the companies as if they were a unified economic entity (in a case of full ownership). The two countries may do so, but at a very great cost, for they will have to compromise on something they hold dear (and is also commercially very valuable) - their sovereignty.

Not surprisingly, only sovereign entities that have transferred some or all of their sovereignty to higher sovereign powers have even attempted to cooperate on such matters. I have in mind political entities such as the United States and the European Union. Only such political bodies may try and achieve the necessary synchronisation and information exchange that stems from the analytical separation of firms and corporations. But even they find it difficult. So, for instance, the United States anti-tax-avoidance policies and rhetoric sound a bit hollow considering that Delaware is one of the least transparent jurisdictions in the world right now. The European Union finds it even more difficult to synchronise the policies of its members, so that by some accounts some very strange countries pop up as leading tax havens, including Germany and Denmark, not to speak of the UK.

Corporations and firms

Whereas so far I described a passive situation that arises out of the confusion between the legal status of the firm and the corporation, all the evidence suggests that firms and their advisors are actively taking full advantage of the situation. There are by now in excess of three million corporate entities of all sorts and descriptions registered in countries known colloquially as tax havens (Palan, Murphy, & Chavagneux, 2010). There are many more corporations registered onshore, numbered in the tens of million, and many of those can be used for such arbitraging purposes as well.

We know little about individual offshore entities– although intensive efforts by the G7, the OECD and the leading economies in the world have resulted in some cracks in the veil of secrecy and opacity that surrounds tax havens. We can find some information about single entities if and when they are singled out by a tax authority or an investigative journalist. But that is a very cumbersome, time-consuming and expensive process. Most firms rely on safety in numbers. The sheer volume of corporate entities in the world, and the complex 'habitat' that they inhabit (the myriad of country rules and regulations, exceptions and amendments) ensure that the very few 'predators' – who are typically relatively poorly paid and subject to intense political and legal pressure behind the scenes to tone down their investigations - catch them out.

We have, however, a pretty good idea of the purpose of those corporate entities, particularly those located offshore, in aggregate. They are used primarily for tax avoidance, possibly evasion and/or regulatory avoidance of financial rules (often presented as avoidance of red tape and/or difficulties in operating internationally) or even avoidance of matrimonial rules (i.e. hiding assets from a spouse, viewed as potential litigant in case of a divorce).

Let us take the example of Apple. On 21 May 2013, the Permanent Subcommittee on Investigations (PSI) of the US Senate Homeland Security and Government Affairs Committee held a hearing to examine how Apple Inc., a U.S. multinational corporation, used a variety of offshore structures, arrangements, and transactions to shift billions of dollars in profits away from the United States and into Ireland (The Permanent Subcomittee on Investigations, 2013). The case centred on Apple's world-wide earnings as the committee has accepted Apple's contention that it paid tax on its US earnings in full. In fact, Apple paid USD 6 billion in 2012 or slightly more than 30% in taxation (Apple, 2014).

This is an illustrative case not only because Apple is such a well-known and profitable brand, but because of the simplicity of its offshore corporate structure. It appears that Apple Inc. had created three offshore corporations in the 1980s in Ireland, a known tax haven, and those received tens of billions of dollars in income. But due to lack of synchronisation among countries in the way they define companies' tax residencies, these Apple corporations have no tax residence – neither in Ireland, where they were incorporated, nor in the US, where the Apple executives who run them are located. They ended up being, as a result, tax exempt.

One of Apple's shell companies is Apple Operations International (AOI). AOI directly or indirectly owns most of Apple's other offshore entities. Under Irish law, only companies that are managed and controlled in Ireland are considered Irish residents for tax purposes. Since AOI is only incorporated, but not managed or controlled in Ireland, it does not count as an Irish tax resident. Under US law, on the other hand, a company is generally taxed on the basis of where it is incorporated, not where it is managed and controlled. Since AOI is not

incorporated in the US, it is not tax resident there either. AOI, therefore, is tax resident nowhere. In fact, AOI has no employees either.

The second corporate shell set up by Apple in Ireland is Apple Sales International (ASI). ASI holds the economic rights to Apple intellectual property rights outside of the U.S. From 2009 to 2012, its sales income amounted to USD 74 billion. Similarly to AOI, the company is incorporated in Ireland but operated from the US. ASI only paid a minimal amount of tax to Ireland. For example, in 2011 it paid USD 10 million against USD 22 billion in revenue. Apple's third subsidiary, Apple Operations Europe (AOE), sits between ASI and AOI. It, too, has no tax home.

Not unlike many firms of its kind, Apple is taking advantage of discrepancies in incorporation and residency rules for tax purposes between different countries. Compared with more sophisticated techniques used by other household name firms, this is one of the simplest schemes of tax minimisation, but one that makes full use of multi-jurisdictional tax arbitrage. Needless to say, it is all legal.

Other schemes are tailored to a specific end. For instance, avoidance of real estate taxation, including capital gains tax, stamp duty and the like can easily be achieved by the re-allocation of the location of sale from the location of the property. Again this is done with the aid of a string of corporations located in different jurisdictions. The real estate property can be owned by a foreign company, the foreign company is owned, in turn, by a holding company in another jurisdiction, and so on. The ownership structure can be repeated as many times as one wishes, through a string of jurisdictions. Any of those holding companies may be sold to a third party in the same jurisdiction (and hence the sale is subject to taxation in that jurisdiction, where, as the case may be, no taxation is imposed). The result is, ultimately, that the real estate asset owned by the string of companies has changed hands but without anything seemingly happening in the country where the property is located. Hence tax is avoided.

There are many other such schemes, each is tailored to specific requirements but all are based on the same principle, the separation between the firm and the corporation.

Conclusion

The implication of my argument is that the key challenge faced by an effective fiscal international regime is to somehow bridge the gap between the firm and the corporation. This is a tough challenge. A solution to the problem of corporate tax avoidance may be considered satisfactory if and when two very serious but radical changes are introduced to the world as we know it. First, we need a complete in the laws, regulations and mores that currently govern the behaviour of corporate entities. Essentially, a new legal entity would have to emerge called something along the lines of an international firm. Such a firm would be treated as unified entity for tax and regulatory purposes and would not be able, at least in theory, to arbitrate among different rules and regulations as a tax mitigation technique. But such a legal entity can only come about if there were to be a complete change in the law of nations, our second change. It would require a global law under which such international firms could be licensed to operate. It would require, essentially, the creation of a world state or a variant of such state!

These two changes are not on the agenda of anyone as far as I can tell. We remain therefore firmly in the realm of second-best solutions. The Levine report proposes one such second-best solution. I quote: "*Apple has arranged matters so that it can claim that these ghost companies,*

for tax purposes, exist nowhere. One has paid no corporate income tax to any nation for the last 5 years; another pays tax to Ireland equivalent to a tiny fraction of 1 per cent of its total income," (The Permanent Subcomittee on Investigations, 2013, 3). The committee proposes, in other words, to distinguish tax avoidance techniques according to the theory of presumed intentionality. If you happen to set up your affairs in a way that minimizes tax profile somehow without knowing it -- that is fine. But if you have done so more recently or intentionally, that is not fine. Well, this distinction is highly problematic.

There are many other proposals being discussed right now, they each address one aspect of that complex world of tax mitigation strategies, but none is able to tackle the predicated source of such strategies, the distinction between firm and corporations. My conclusion, therefore, is that the battle against corporate tax avoidance will have to be decidedly practical and empirical. My hope is that as countries better understand the intricacies of tax laws and the problems of diverging sovereign rights, they are increasingly likely to develop ever more effective and innovative techniques for combating tax abuse. I believe that we are, at best, only half way through a long and meandering journey that will eventually lead to policies that will have an impact on tax abuse.

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Tax avoidance: the missing link in business & human rights?

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Last year, I participated in the annual sustainability forum of a global food and beverage company that is highly regarded for its corporate social responsibility policies. The Chairman confidently spoke about the progress made on combating land-grabbing, supporting freedom of association, and providing access to water. But when somebody mentioned tax avoidance as a human rights issue, he retorted that it was the first time he had heard "tax" and "human rights" mentioned in the same phrase. While the last 15 years have seen a fast-paced increase in businesses' awareness of their responsibilities towards human rights, the same cannot be said about seeing tax avoidance as a key corporate responsibility issue, and much less as a fundamental human rights issue.

Despite that, in recent times much has been written about allegations of large-scale tax evasion by corporations, using loopholes, tax havens and lack of government regulation to deprive societies, both north and south, of billions of dollars in taxes and royalties. But what is still not widely recognised is that these practices strip developing countries of the resources necessary to deliver human rights to their populations.

NGOs have been trying to draw attention to the link. Action Aid, Tax Justice Network, Christian Aid, and Oxfam, among others, have researched and campaigned on the link between avoiding paying a fair share of tax and the deprivation of such basic services as health, education, housing, access to water and other human rights. It has also been repeatedly reported that developing southern hemisphere countries lose much more money to tax evasion and illicit financial flows than they receive in international aid; by some estimates, countries lose three times more to tax havens than they receive in aid[3]; others say shifting profits to jurisdictions where taxes are lower or non-existent, "*robbed developing countries of $4.7 trillion, which is nearly six times the amount of official development assistance they received during the same period.*"[4]

How do companies do this? There are a host of different methods. It is important to note that although a lot is lost to illegal tax evasion, more is lost to nominally legal tax avoidance and

[3] http://www.un.org/africarenewal/magazine/december-2013/illicit-financial-flows-africa-track-it-stop-it-get-it

[4] https://secure.avaaz.org/en/petition/UN_Secretary_General_Ban_Kimoon_Tell_the_UN_to_put_a_stop_to_tax_abuse/?nPQQoib

aggressive tax minimisation tactics. Methods include non-payment of taxes through agreements with governments, subsidies, loopholes, tax havens, creative accounting practices, transfer pricing, and others. And though these methods are usually legal under national laws, concerns are raised about whether aggressive tax planning is moral and complies with international standards; in particular, with the obligation of companies to respect human rights under the UN Guiding Principles on Business & Human Rights (UN GPs), endorsed by the UN Human Rights Council in 2011 and supported by governments and businesses around the world.

The UN GPs set out a global standard of conduct for all business enterprises wherever they operate[5]:

"...business enterprises have responsibility to respect human rights, also in their business relations, which requires them to:

(a) Avoid causing or contributing to adverse human rights impacts through their own activities, and address such impacts when they occur; and

(b) Seek to prevent or mitigate adverse human rights impacts that are directly linked to their operations, products or services by their business relationships, even if they have not contributed to those impacts."

Nobody questions that businesses are important partners in the fight against poverty, but they also have the responsibility to respect human rights throughout their operations. Business enterprises - including tax advisors, accountancy firms, law firms and financial institutions - need to understand that their tax planning strategies and services can negatively impact on human rights, and conduct appropriate human rights due diligence. Due diligence is required by the UN GPs.

A recent report from the International Bar Association entitled *Tax Abuses, Poverty and Human Rights*[6] makes the case for framing corporate tax abuse as a human rights issue. The report says that transfer (mis-)pricing; negotiation of tax holidays; (non-)taxation of natural resources; the use of offshore investment accounts; all of these can seriously deprive governments of the resources needed to address poverty and to finance programs seeking to protect and fulfil internationally recognised human rights.

As the body of literature and campaigns making the link between tax avoidance and human rights grows, so does the heat that some companies are feeling. To give just two recent examples:

1. A September 2014 University of Manchester study found that South Africa's diamond industry is benefitting from royalty and export tax structures, "riddled with loopholes, short-changing citizens of one of the world's premier sources of diamonds of tens of millions of dollars a year in revenue." The report states that the main beneficiary of a system tilted in industry's favour is De Beers. De Beers responded saying the report fails to recognise their economic contribution to South Africa, which, "goes well beyond our tax obligations including ZAR 6.1 billion in taxes between 2008-2012"[7].

[5] Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework, UN Doc. A/HRC/17/31, par. 11.

[6] Available at http://business-humanrights.org/sites/default/files/media/documents/taxabusespovertyandhumanrights.pdf

[7] See report, related materials and De Beers response here: http://business-humanrights.org/en/so-africa-rough-and-polished-report-alleges-tax-avoidance-by-diamond-mining-companies-de-beers-denies-claim

2. This is a global phenomenon that also affects rich countries: a July 2014 Guardian report alleges that restaurant group Nando's uses a battery of offshore techniques to legally reduce its UK corporation tax bill by up to a third. Nando's refuted the claims8. Similar allegations have been raised in the UK against Starbucks, Google, Amazon, and others9. The UK Government published in March 2014 a proposal for new international rules to address cross-border business structures or finance transactions and a disclosure scheme for international tax schemes, in the context of its ongoing work with G20 and OECD countries[10].

The issue of tax avoidance has been high on the agenda at recent G8 and G20 summits, but little concrete action has come out of these events. Multi-stakeholder initiatives have been set up to deal with aspects of the problem, such as the Extractive Industries Transparency Initiative (EITI), a coalition of governments, companies and civil society working, "*to improve openness and accountable management of revenues from natural resources.*"

Some companies have taken an actively progressive approach in this area, which proves that much more can be done in this area even before civil society manages to force government to close loopholes and eliminate tax havens. For example, the Co-operative Bank said: "*One of the most effective ways that businesses can contribute to poverty reduction is to pay income tax in developing countries.*"[11] Publish What You Pay, an NGO, praised Rio Tinto in 2009 for voluntarily disclosing, for the first time, the total tax and royalty payments that it makes to 13 of the countries where it operates.[12]

While there have been important advances, a large number of companies still fail to disclose the tax and royalties they pay in each country. Much more action is needed by governments, individually and collectively, to address tax avoidance through improved laws and enforcement. But companies are responsible for their own tax practices, and they can take corrective actions now, if they are serious about their human rights commitments. Companies should recognise that the long-term gains of achieving more equitable and developed nations in which their business could flourish far outweigh the short-term benefits of an inflated profit margin attained through dubious means.

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International taxation challenges

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Introduction

Many of today's articles about business taxation start with some reference to the unprecedented interest that politicians, journalists, NGOs and campaigners – and the public – now have in taxation. This article looks back at the foundations of concern about taxation and reflects on measures being taken by governments, business and advisers to respond.

Background

We can trace the roots of this interest back for at least fifteen years but many missed those initial signs at the time, or failed to anticipate how the area might develop. Three or four areas have become entwined: tax evasion, corruption, aggressive tax avoidance and out-of-date structures for international taxation.

Tax havens are also an important part of the issue, as they were being used by some multinationals for tax planning and by some for personal tax evasion and receiving hidden payments.

The OECD produced its first report on Harmful Tax Practices in 1999, challenging tax regimes that offered the potential to record substantial amounts of taxable profit without related people-based activities. The European Union set up a group to look at harmful tax practices and established a Code of Conduct group, which reported to the Council of Finance Ministers (ECOFIN) where it found harmful activities within the EU and related territories. Yet these initiatives failed to gain momentum. OECD governments seemed disinclined to take significant action. The EU managed only to identify one significant harmful regime – the Belgian coordination centre – which it then allowed to be replaced by a notional interest regime.

The war on tax evasion was starting to heat up, though. Jon Christiansen founded the Tax Justice

Network in 2002, initially to campaign against tax evasion and the secrecy which permitted this undesirable activity to flourish. The EU finally managed to introduce the Savings Directive in 2005, which provided for the automatic exchange of information in fairly limited circumstances, while allowing three EU Member States and associated territories, including Switzerland, to levy an anonymous withholding tax instead.

Digitisation turned out to be the lever that tax authorities could use to break down offshore secrecy. In the UK, the tax authority obtained orders requiring that leading UK banks disclose to them details held in the UK of offshore accounts. In 2006, the Offshore Disclosure Facility launched, which offered a low penalty rate to individuals who came forward and paid tax due, with interest. Leaked data, purchased in some cases by tax authorities, led to formal agreements with Liechtenstein for data to be passed to other countries.

In the United States, the discovery that some Swiss banks had actively supported tax evasion by their customers led to a sea change in approach. Over time, the Swiss acknowledged that bank secrecy should not be used to permit tax evasion and agreements were signed with the UK and Germany to provide for the payment of some tax due from the past. Perhaps the financial crisis from 2007 also led to a change in the way governments approached tax evasion: the announcement by the United States of the FATCA law in 2010 triggered wholesale change globally regarding the sharing of data to reduce tax evasion.

UK development charities joined the campaign in 2008, when Christian Aid's publication entitled Death and taxes, asserted that tax evasion and tax avoidance in relation to developing countries led to deaths of some of their citizens. ActionAid followed up and both published several more reports along similar lines.

In the United States, Senator Carl Levin called a number of US multinationals before the Senate Committee on Investigations, where a range of chief executives acknowledged that their corporations paid little tax outside the United States and many had built up substantial cash balances, also outside the US. Some called for tax reform to change an unstable tax system.

In the UK, the cross-party Public Accounts Committee chaired by the Rt. Hon Margaret Hodge MP criticised the tax authority's settlement of past tax issues with a range of multinationals. The tax authority (HM Revenue & Customs) acknowledged there had been a lack of internal governance in respect of five cases – which led to the appointment of a High Court judge to review those cases. The judge pronounced that the five resolutions were actually reasonable outcomes and HMRC took steps to improve its governance generally. The Public Accounts Committee then moved to consider personal tax avoidance – which had become a significant issue in the UK, with HMRC pursuing cases worth over £7 billion. There then followed several hearings involving the tax strategy of three US multinationals – where Mrs Hodge made the famous comment, "we are not accusing you of being illegal; we are accusing you of being immoral." Finally the Public Accounts Committee took evidence from representatives of the Big 4 accounting firms, including the author.

What can we take from this? Governments and politicians generally have a sense that parts of the tax system are not working as they should. It turns out that tax evasion using offshore finance centres was more important than had been appreciated. Many low-income developing countries suffer from corruption and a lack of structures to collect tax. In some countries – such as the United States and the UK – a small number of high-earning individuals had invested in tax schemes to cut their tax bills. International corporate taxation concepts had

languished whilst business models and digital business developed. The public has a lack of understanding of how business works (including basic concepts of what a profit is) and also has a lack of trust in some of the institutions, which is a much wider point than taxation. It does however feed into what the UK's CBI, which represents 190,000 companies in the UK, calls a lack of trust in business.

Where now?

Governments globally are adopting a twin approach to counter offshore evasion and reinvent the design of international corporate taxation.

The strategy to counter offshore tax evasion has now been put in place and will be implemented over the next three or four years. FATCA reporting will start later in 2015 and in 2017 the first adopters of the Common Reporting Standard (CRS) put in place by the OECD will start to deliver information. The CRS has been adopted by over 80 countries, including most significant financial centres. It will reduce the scope for personal tax evasion. No one should underestimate the scale of the challenge that FATCA and the CRS places on financial institutions. Major systems changes are needed and considerable amounts of new data must be gathered. Tax authorities will also need digital systems to process the data they receive. The UK also led a call at the G8 Summit in June 2013 for better information on who owned private companies. The UK has announced that a public register would be developed by April 2016. The EU is expected to legislate in 2015 that all Member States set up central registers of company and trust ownership for access by tax authorities and others. The information on company ownership should be made available to investigative journalists and others with a legitimate public interest.

The G20 asked the OECD to lead the Base Erosion and Profit Shifting (BEPS) project in November 2012. The objective of BEPS is to modernise the rules of international corporate taxation, to reflect modern commerce and take account of the rapid growth of digital activities. The intended outcome is that companies should have greater taxable profits than before – no doubt paying additional tax. The project teams are working to an incredibly short timescale to deliver such an ambitious project. It's clear that the sheer size of the group – now over fifty countries, potentially with a range of objectives - may limit the chance of a fully harmonised outcome. Nonetheless there is sufficient political momentum for major changes to international corporate taxation. In future, it is likely there will be greater alignment between taxable profits and people-based activities. The changes are likely to be complex, with greater potential for dispute over the right level of tax and higher compliance costs.

Tax authorities have needed to modernise and, where relevant, put in place new systems to provide greater transparency about their approach to major taxpayers – both corporate and personal. Some are using new approaches to challenge perceived tax avoidance – either by putting forward new arguments based around abuse of law doctrines, or seeking greater investigative powers and statutory general anti-abuse rules. Digitisation of tax compliance systems has the potential to reduce costs, whilst enhancing effectiveness, but in many countries are still in the process of development.

Major advisory firms face the challenge of adapting their advisory services to the new world. In the UK, many firms have set up panels to consider the judgments needed in giving advice that reflects today's environment. Globally, firms have published their codes of conduct, which set out at a high level how each works in giving advice. Perhaps the most common statement is that advice is given only in

connection with a client's commercial objectives. Professional bodies in the UK have updated the overriding guidance for their members, covering for the first time advice on tax planning and tax avoidance.

What about business? The first challenge is over the wider governance of taxation. Perhaps twenty years' ago, tax planning and tax compliance was left to the finance team. Today, publicly-quoted multinationals ensure that their tax policy and strategy is managed by the Board of Directors. Tax authorities – led by the Australian Tax Office – seek engagement with Boards to ensure that the directors are taking proper responsibility for the systems and policy choices inherent in taxation.

The major challenge remaining for business is what to say publicly about taxation. Given that few readers will understand the details of taxation, many publicly-quoted companies have sought to expand the narrative included in annual reports and financial statements and highlight the tax issues affecting the group. Some companies have started to report their total tax contribution – which shows all the tax that a company pays and collects. Arguably this is the best measure of a company's total contribution, since in many countries tax on profits is less significant than other taxes, such as payroll and property taxes. A few have started to publish more data on where they pay their tax but the complexity of gathering this data has meant that most cannot provide this when they publish their financial statements. It's probably fair to say that none of this has convinced NGO critics, who argue that even greater public disclosure is needed.

Perhaps the answer is that we are in transition to a new tax system over the next few years. Only when the new approach is fully in place will we be able to judge its success.

Not There Yet: Despite strides, Europe still has work to do on financial transparency

A joint contribution by The Financial Transparency Coalition (FTC)

The Financial Transparency Coalition is a global network of more than 150 allied civil society organisations, fourteen governments, and dozens of the world's foremost experts on illicit financial flows. We work to curtail illicit financial flows through the promotion of a transparent, accountable and sustainable financial system that works for all.

Porter McConnell is the Director of the FTC.

Just before the G20 Summit in Brisbane in 2014, dozens of newspapers across the world simultaneously released stories about a new trove of leaked documents. But these leaks weren't about government surveillance or secret diplomatic cables, and were unlike other high-profile leaks in the past few years.

This time, the headlines concerned Luxembourg and secret tax arrangements it entered into with more than 350 multinational corporations. The documents, leaked to the International Consortium of Investigative Journalists, showed that corporations were routing profits from other countries of operation into Luxembourg, in some cases to be taxed at rates of less than 1 per cent.

Household brand names, from the likes of Pepsi, IKEA, and FedEx, apparently used these arrangements. The issue even made its way to the world stage at the Brisbane G20 Summit, forcing Jean-Claude Juncker, President of the European Commission, to answer pointed questions about profit shifting and the perception that Luxembourg offered a loophole that allowed these corporations to significantly reduce their tax liability elsewhere.

Perhaps more importantly from a policy perspective, these leaks came about in the midst of a heated discussion on the future of financial transparency in the European Union. The European Parliament, European Commission, and European Council were negotiating an updated version of the European Anti-Money Laundering Directive (AMLD). A portion of the AMLD involves updating requirements on the collection of beneficial ownership information—in other words, collecting information on who ultimately owns or controls a company.

This type of information is key to tracking a whole host of criminal activities, from human and drug trafficking to state embezzlement and corporate tax evasion. Being able to set up a company—which has the ability to move money, open subsidiaries and act as a legal front—without providing information on who ultimately owns it is a recipe for disaster. Matters are only made worse when such companies are in turn owned by yet another company in a separate jurisdiction with different secrecy laws. The result mimics a vast spider's web, branching out in tens or hundreds of different ways, creating a nearly indecipherable puzzle.

These webs of corporate secrecy often stop investigators right in their tracks; making it hard

for authorities to tell whether profits are real or manufactured, hard for governments to invest in the infrastructure that drives growth, and hard for citizens to keep their leaders honest.

But there are solutions.

One cost-effective way of cutting illicit flows is to make it harder for perpetrators to hide. Establishing registers that collect information about who is really controlling a company, and making that information public, can help facilitate the due diligence obligations of banks and other financial services that are at risk of seeing corrupt or stolen money. Registers would also help authorities track the corrupt politicians, corporate tax evaders and criminals who flourish in this secrecy. And having to disclose ownership details upfront may also have a deterrent effect, since covering your tracks would become all that much more difficult.

At the same time, businesses would gain because it would help prevent them from falling victim to the types of shams that shell companies can help perpetrate.

Transparency simply makes for better investments.

The European Parliament already endorsed EU-wide public register with a vote in March of 2014. After deliberations with representatives of EU Member States, a compromise was reached that would create national-level registers of beneficial ownership. But instead of the public access parliamentarians wanted, the data would only be open to authorities and law enforcement, with NGOs provided access if they can pass a so-called legitimate interest test.

As this process still plays out and the text is officially made into law sometime before summer, there is a more fundamental question to ask: are we really giving up something by making it harder to set up a company anonymously? Might there be legitimate reasons to do so?

Mo Ibrahim, a mobile communications mogul, perhaps summed it up best in August during the US-Africa Summit when he stated that, "there is absolutely no good reason for someone to have an anonymous company." And according to Global Witness, a London-based campaign organisation and member of the Financial Transparency Coalition, there are certainly a multitude of bad reasons. In its report, *The Great Rip Off*, they documented 56 cases of shell companies that helped to perpetrate crime, fraud, and corruption.

Others in the business community are also supportive of financial transparency measures. The B Team, of which Ibrahim is a member, is a group of high-profile business leaders who have recently been making the business case for beneficial ownership disclosure.

This information would let investors vet whether or not a corporation is operating in politically unstable areas, tax havens, or other sensitive regions. Investors doing their due diligence want to be thoughtful when it comes to where and with whom a potential partner does business.

In a survey carried out last year by Price Waterhouse Coopers (PwC), more than 59 per cent of CEOs questioned said they would support companies publishing country-by-country financial information, which would include information on profits, losses, taxes paid, number of employees, and other relevant company data. Armed with this information, authorities, researchers, journalists, and the public could monitor corrupt practices, tax payments, and determine who owns the companies conducting business in their country.

Some in the business community are seeing the writing on the wall; Barclays Bank voluntarily began releasing its own financial information on a country-by-country basis in 2014, prior to a

new EU requirement to be applied from 2015 onward.

It's reasonable to ask whether the measure would deter investors and hence have a negative impact on the economy at large. The European Commission had the same worry, and commissioned PwC to research the matter. In an exhaustive report released recently, PwC came to the conclusion that public country-by-country reporting of financial information would have no significant negative economic impact, either on competitiveness, investment or the stability of the financial system. Over the course of their research, they actually found that there could be some positive impacts from such reporting.

European governments are beginning to make serious strides, too. While the AMLD set up central registers with limited access to the public, the UK, France, Denmark, and Austria have all shown support for fully public registers. Early next year, the UK will launch the first fully public register in an EU country, populated with beneficial ownership data on UK-based companies.

The Luxembourg leaks made a huge splash in the media; but as the media wave begins to dry up, it's vital to look towards the transparency initiatives that would make waiting for the next leak simply irrelevant. As more governments, businesses and members of the public begin to speak up, the measured transition from secrecy to transparency is all but inevitable.

Answering key questions of tax policy

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She is a Corresponding Member of the National Academy of Sciences of Ukraine, Doctor of Economic Sciences. She occupied the posts of Deputy Minister of Finance of Ukraine, Chairman of the Zaporizhia State Tax Administration and the Head of the Division on Economic and Ownership Issues in the Zaporizhia region. She has been responsible for economic reforms of the Ukraine's public sector and headed development of the Tax Code and the Budget Code. She initiated updates to the Customs Code and has worked on simplifying business regulation and on social support.

What role, if any, do you believe the concepts of fairness and fair play should have for taxation?

The essence of taxation in the regulatory process is constantly changing, in response to specific aspects of the socio-economic system and technological progress. Through various mechanisms the public sector budget is filled with tax revenues, thus making funds available for public functions. But the goal is not simply to collect more taxes and thus cover expenditure. In certain circumstances, a reduction of the tax burden can increase revenues.

An important consideration is ensuring more justice within the tax system. Taxpayers' circumstances differ markedly. Some economic agents bear the entire tax burden, while others minimise their tax liabilities through illegal contracts. Taxation must not be politicised, or become opportunistic in nature, nor impede competitive pricing processes, hinder accumulation of savings, etc. Taxation can be diversified or confined to one or a limited number of taxes.

Fiscal policy should avoid complicating the process of economic decision-making by producers and consumers and respect the principle of neutrality. Setting common fiscal priorities, whilst allowing for the characteristics of various operational activities and consumption types, is influenced by the concurrent conflicting processes of international tax competition and policy coordination, at the international and national scale. International practices, as well as historical and domestic experience suggest that the global environment requires a strengthened regulatory function for taxes – alongside their fiscal function – based on principles of justice, equality, and neutrality at the macro and micro levels.

Given present-day international tax competition, institutional capacity and know-how has become even more significant than the ability to set the various quantitative parameters of the fiscal burden. It is all about achieving simplicity and

fairness of mandatory payments and regulatory legislation, as well as compliance of key tax provisions with human values, and the long-term sustainability of fiscal policy.

With this in mind, compliance by all participants in the tax relationship, i.e. honest exchange by the public and business, is required to respect the principle of fiscal burden voluntariness. Opportunistic behaviour of citizens and businesses in relation to taxes usually results from a negative perception of the services' cost to benefit ratio. Motivation for tax evasion is driven by contradictions between the formal and informal rules of the game, and their systematic violation. Moreover, the inequality of the tax burden among various industries due to privileges, granted under the influence of political groups representing different business interests, distorts competition. As a result, businesses are forced into, or consciously withdraw, into the shadow economy and optimise transaction costs by reducing non-productive spending.

Is tax competition between nations a good thing or a bad thing?

The main instruments of international tax competition are: a relative reduction of the fiscal burden by some countries as compared to others and the simplicity and fairness of the administrative procedures for mandatory payments. Competitive advantages, along with lower tax rates and various benefits, may include positive assessments of legal stability, ease of doing business, especially in terms of reporting requirements, and commitment to neutrality and fairness.

International tax competition is not limited to governments' ambition to attract foreign investors into their fiscal jurisdiction for capital taxation; it also contributes to competition between the states for growth and creation of added value. Thus, mobility is a significant factor determining a business's competitive advantage potential. Globalisation limits the tax sovereignty of national governments, making it impossible to establish excessively high rates of both direct and indirect taxes, since the mobility of taxpayers involved in foreign trade enables them to quickly move the assets and business to the country with the most favourable tax climate. Integrated into the global economic system, nations not only compete to attract foreign investors, they also seek to strongly stimulate residents' activities in local and international markets.

An important factor that enhances or limits the impact of tax competition is the economy's potential market capacity and institutional restrictions on residents' access to foreign markets.

International tax competition should not be viewed positively or negatively. It is an objective phenomenon, characterised by fiscal rules and regulations in sovereign countries. The post-crisis development of the global economy since 2010, has been characterised by, on one hand, liberalisation of national economies to increase their efficiency and to stimulate increased production and competitiveness, and, on the other hand, enhanced measures of state protectionism.

Unfair competition in the global economy should be combatted by the expanded and intensified unification of tax bases for the calculation of indirect taxes, as well as uniformity in regulations for multinational companies' operations, especially for those having branches in offshore areas. It is also important, within the framework of international cooperation, to strengthen administrative provisions relating to evasion of mandatory payments, including those designed to combat fraudulent schemes of transfer pricing and aggressive tax planning.

The same approaches are also needed to assess the level and competitiveness of the fiscal system, the tax burden on labour, capital and consumption, in particular using analysis and comparison of implicit compulsory payment rates, primarily on the basis of EU Member States' practices. It is important to continue improving the VAT regulations by eliminating some benefits and reduced rates, setting uniform excise tax and creating better mechanisms for taxation on fixed assets, including property and natural resources. In the context of fiscal consolidation, given the general trends of climate change, it is necessary to develop common approaches to efficient use of energy taxes, including contributions for carbon emissions.

What role do you see, if any, for tax policy in making our economies more competitive, less carbon intensive and our social model more sustainable?

Fiscal consolidation plays a key role in preventing negative economic consequences in the context of macroeconomic instability, large budget deficits and aggravation of debt problems.

Generally speaking, taxes play an important role in public life and in particular in the distribution of revenues generated by the economy. In state regulation of production, the potential of taxation to support sustainable operations of all parts of the economic system should form part of the taxation strategy. In practical terms, taxes significantly affect cash flows, so their effects should be carefully balanced.

The need for government regulation of the economy by taxation stems from the state's objective economic functions. Where different forms of business ownership exist, the role of government tax regulation is, on one hand, to provide a mechanism for implementing ownership, and, on the other, to ensure compliance with social standards (as the failure to address the needs of society could cause the collapse of the entire political and economic system). To deal with both situations, different methods of taxation (progressive, neutral, etc.), as well as preferences and exemptions (both for entrepreneurs and for certain segments of the population), are typically introduced.

Within the framework of managing economic systems many aspects are influenced by financial and fiscal policy, including: business cycles; currency trading and balance of payments; sectoral, branch and regional structures of the economy; foreign economic relations; competition and wealth creation; and environmental protection. Innovative regulatory mechanisms must be consistently replenished with tools that obstruct capital outflow and support the social security system. Particularly relevant when combating such phenomenon is shifting the tax burden from labour and capital to consumption, the use of resource charges and environmental levies.

Tax avoidance and international tax competition: a serious long-term threat to the welfare state and democracy

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Introduction[13]

In order to understand the unexpectedly vehement reactions of some governments to international tax avoidance and the moral outrage of many citizens that stands behind it, it is important to be aware of its potentially destructive effects on the welfare state and – in the end – on democracy. Tax avoidance does not merely constitute some kind of technically smart arbitrage between exogenous international tax laws, but instead it has been one – and maybe the most important – of the driving forces of international tax competition with its ever decreasing statutory tax rates on top personal, corporate and capital income in general. The decrease in tax rates was followed by an increase in the disparity of income distribution in most industrialised economies and is increasingly threatening the revenue basis of the welfare state which in turn is a basic pillar of Western industrialised countries' democracies.

Taxation trends since the 1980s: dramatic decreases in statutory tax rates[14]

Since the 1980s at the latest, the top personal income tax (PIT) rates declined in nearly all OECD countries. In 1981, the top combined statutory PIT rate in the OECD countries was on average 65.7 per cent. If one considers the countries that were already included in the 1981 dataset, the average rate declined to 50.7 per cent in 1990, to 48.9 per cent in 2000, and to 45.8 per cent in 2010 (OECD, 2012b, p. 33). In the meantime other countries have joined the OECD; if they are included the average tax rate in 2010 was only 41.7 per cent.

More recently, many European governments also deliberately broke with the comprehensive income approach by subjecting the capital income of individuals to a separate tax schedule

[13] Parts of this paper draw from results of the work package 'Redistributive Policies' within the Global Labour University research project 'Combating Inequality' financed by Hans Böckler Foundation, Düsseldorf, Germany. (http://www.global-labour-university.org/353.html).

[14] For a more extensive overview, see Godar and Truger (2015).

with a single tax rate while retaining progressive taxation in the area of labour income. In many OECD countries (for example Sweden, Finland, Austria, Germany, Spain, Ireland and Japan), certain types of capital income of individuals (such as interests, dividends and capital gains) are excluded from progressive income taxation (OECD, 2013a; Deloitte, 2013). As Schratzenstaller (2004, p. 23) pointed out, many West European countries have reformed their taxation of capital income since the early 1980s, moving away from the comprehensive income approach and towards a 'dualisation' of the income tax. Capital gains are most frequently taxed at a rate lower than the individual marginal tax rate. Additionally, there are manifold tax reliefs, which apply to different types of capital gains (Deloitte, 2013). Since 1981, the maximum overall tax burden on dividends has declined significantly (OECD, 2013a).

The taxation of corporate income has witnessed nearly three decades of an international race to the bottom in terms of nominal corporate tax rates. An examination of the countries for which OECD data have been available since 1981, finds that the (unweighted) average combined corporate income tax (CIT) rates declined by more than 20 percentage points – from 47.5 in 1981 to only 27.2 in 2012. The average reflects the individual trends quite well as virtually all countries in the sample cut corporate tax rates significantly.[15]

Of course, due to the complexities of the economic and political processes, it will never be possible to prove that the taxation trends have indeed been caused by international tax competition, which in turn has been caused by tax avoidance behaviour. Indeed, other factors like the hope of increasing economic incentives, foreign direct investment or simply changing distributional preferences may also have caused or contributed to the development of tax rates. However, adjusting to the necessities of international tax competition has always been an important argument and the fact that, especially, international corporations can avoid taxes by using differences in international tax law should not be news to tax professionals and is by now widely accepted. According to the OECD's (2013b) comprehensive report on Base Erosion and Profit Shifting, multiple opportunities exist for corporations to shift income among entities and thereby to countries where lower tax rates or special exemptions are applied. Examples for such opportunities are using licences for brands, patents, or other financial services provided by a foreign subsidiary in a low tax jurisdiction as well as the manipulation of transfer pricing. Obviously, firms are using these opportunities: the OECD (2013b, p. 17) observes that in 2010 Barbados, Bermuda, and the British Virgin Islands received, as a group, 5.11% of global foreign direct investment (FDI), which is more than Germany received (4.77%).

Pressure on traditional standards of distributive tax justice and erosion of governments' revenue raising potential

Matters of income distribution and redistributive taxation require normative standards of equity or tax justice. Although the traditional distributional goals of taxation were never uncontested, there used to be a widespread consensus as to employing the 'ability to pay' principle in the determination of the tax burden. The criterion of horizontal equity implies that taxpayers with the same ability to pay should be treated equally by the tax system.

[15] More sophisticated measures for effective tax rates such as the Effective Marginal Tax Rates (EMTR) and Effective Average Tax Rates (EATR) on new investment based on microeconomic models of investment (Spengel et al., 2012) as well as the aggregate implicit tax rates calculated by Eurostat **(EC, 2012, p. 257)** broadly show a similar picture.

The ability to pay can be measured in terms of income, wealth, and expenditure. According to the Haig-Simons definition, "income is the money value of the net increase in an individual's power to consume during a period," (Rosen & Gayer, 2008, p. 382), i.e. savings and capital income are also included in the determination of the ability to pay, as they represent an increase in potential consumption. Although difficult to apply in practice in a completely consistent manner, this was interpreted as calling for the comprehensive income approach to taxation, excluding systematic tax privileges for specific sources of income. According to the sacrifice approach used to operationalise the dimension of vertical equity (Prest, 1960, pp. 115), a tax system should impose the same sacrifice on the taxpayers whose individual utility is reduced by the tax. Due to the diversity of possible sacrifice approaches no overall conclusion can be drawn for the desirability of progressivity, so that an additional value judgement is required (Prest, 1960, p. 117). However, in the past it was widely accepted that some – and indeed a high – degree of progressivity was socially desirable in rich industrialised countries.

However, these goals have come under increasing pressure since the 1980s. As was already mentioned, the trend towards dualisation is a main deviation from the principle of avoiding tax privileges. What is more, according to the OECD (2011a, p. 267), market incomes have become more unequal in most OECD countries since the mid-1980s. Additionally, redistribution by the state has on average become less effective, especially since the mid-1990s. It is impossible to establish exactly the extent to which changes in the tax system are responsible for this state of affairs.

Nevertheless, the general taxation trends, as reflected in the important indicators mentioned, point to a clear connection. Strong drops in the top marginal income tax rates, in the corporate income tax rates, as well as an increasing dualisation of the income tax (that is, increasing privileges for income derived from capital) demonstrate that the traditional standards of tax justice have come under severe pressure in recent decades.

The decreases in tax rates have led to negative revenue effects: On average, taxes on personal income used to be the most important source of revenues for OECD countries. They accounted for about 30 per cent of total tax revenues in the 1980s. Since then, their relative importance has declined to about 24 per cent while the weight of social security contributions has increased (OECD, 2012a, p. 23).

However, one should note that the falling tax rates are at first sight not reflected in the revenues generated as far as the CIT is concerned: until 2007, corporate taxes as a percentage of GDP increased significantly in most OECD countries as compared to the levels of the 1970s and 1980s. Despite declining considerably in 2008-09, the average level in 2010 was still higher than in the 1970s and 80s. Part of the explanation of this puzzle may be that declining nominal rates were to some extent accompanied by measures to broaden the tax base. Another explanation may be that growing incorporatisation due to the dramatically reduced CIT rates has been boosting CIT revenues at the expense of the PIT (EC, 2010, p. 23). However, the most likely cause of the strong development of corporate tax revenues lies in the rising share of corporate profits in GDP (Devereux et al., 2004, p. 26), i.e. in a shift in the income distribution towards corporate profits.

The same applies for property taxes: Compared to the 1970s, the revenues from property taxes as a percentage of GDP have on average remained fairly stable in the OECD countries. This points to a considerable fall in the effective taxation of private wealth, because as shown by

Piketty and Zucman (2013) since 1970 the ratio of private wealth to national income has risen considerably in many rich countries. Hence the development of property taxation has negatively affected both tax justice and income distribution.

One may argue that the declining tax rates on high personal, corporate and capital income may have had negative distributional implications, but that they have so far not eroded the revenue potential of the welfare state (e.g. Hines 2006 and Eicker-Wolf and Truger 2014). However, due to important indirect effects this is more than unlikely.

First of all, it is questionable whether the redistribution in favour of capital and high incomes that was witnessed for many years and that was the basis for stabilising revenue from the relevant sources can go on forever. Indeed, the high overall growth rates that were necessary to attain broad acceptance for the growing inequalities, have proven not to be sustainable because they had been driven by unsustainable (mostly) private debt dynamics which have become impossible after the Great Recession.

Second, even if the redistribution was to go on further, a growing sense of injustice regarding the contributions to the welfare state would most probably undermine the legitimacy of the welfare state leading to most destructive political struggles and social unrest. The political and social unrest caused by the – broadly inequitable – austerity measures in many Euro area countries may serve as a daunting example of the destructive potential of the current trends.

A lack of growth and employment[16]

The standard arguments in favour of lowering tax rates on capital and the well-to-do claim that it would create positive incentives for private households and firms and decrease tax avoidance behaviour. However, it can be argued, on the basis of mainstream microeconomic arguments (e.g., Rosen and Gayer, 2008; Salanié, 2011), and other literature, that these effects need not be important. This suggests that the equity/efficiency trade-off is probably rather small if it exists at all. What is more, factors other than taxation (the cyclical condition of the economy, infrastructure investment, research and development expenditures, and the educational system as a provider of a qualified workforce) may be much more important. If these factors can be enhanced through government expenditure, financed through progressive taxation, then the overall economic effect of the latter may well be positive.

From a macroeconomic perspective, it is possible to even further strengthen the case for redistributive taxation.[17] If the economy is constrained by insufficient demand and if inequality is detrimental to private consumption, redistributive taxation may strengthen growth and employment via the resulting increase in private consumption. Additionally, financing public spending by additional taxation would usually be growth enhancing, because the negative effects of taxes would be overcompensated by the positive effects of public spending.

[16] For a more extensive overview and discussion, see Godar and Truger (2015).
[17] For a more extensive overview and discussion, see Godar et al. (2015).

No substantial trend reversal on the way

In the face of rising inequality and strong budgetary pressures in many OECD countries since the Great Recession, there may be some signs that the downward trend in redistributive taxation may have come to a halt recently.[18] In the majority of the OECD countries, top statutory income tax rates were increased after the financial crisis (IMF, 2013, p. 26). Since then, a number of countries have also increased their maximum tax rates on the capital income of individuals. Remarkably, since the economic crisis the average level of corporate tax rates seems to have stabilised (OECD, 2013a) while some countries saw a broadening of the corporate income tax base.

However, whereas the developments mentioned are steps in the direction of greater tax justice, there are also some steps in the opposite direction: since 2009, many governments have raised their value added tax rates in order to generate additional revenues (EC, 2013, p. 31; IMF, 2013, p.26). In addition, there were numerous increases in excise taxes. As pointed out by the European Commission (EC, 2013, p. 30), the revenue generating measures since 2009 have heavily focused on consumption taxes, which are regressive in nature, constituting a clear move away from tax justice and redistribution.

Outlook: time for tax professionals to take sides

Tax professionals should probably not be blamed morally for helping to minimise the tax costs of their clients given the existing competitive pressures in the international economic and taxation framework. However, they should be aware of the long-term destructive effects of their behaviour on the welfare state and democracy. If tax professionals share some of the basic norms of our democratic societies (which I am sure they do), it is in their own interest to care about such effects and help in the design of an (international) tax system that better suits the revenue-raising and distributive needs of our welfare states and democratic societies.

It is time for tax professionals to take sides.

[18] For a more extensive overview see Godar and Truger (2015).

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A fair tax policy is good economics

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Introduction

New thinking since the financial crisis has turned traditional assumptions of economics on their head. The neat division between the economist's concern with efficiency and maximising wealth, and the politician's concern with equity and distribution of wealth, can no longer be seen as valid.

A more equal distribution of income and wealth is a *precondition* of economic success, not simply an outcome of the economic system to be dealt with after the fact. Large and growing disparities of income, wealth and debt undermine the stability of the financial system, greatly increasing the chance of financial crises. Excessive inequality also creates recessionary pressure by undermining consumption – the primary driver of high-income economies.

Tax policy plays a critical part in achieving greater equality, and we discuss below the policy priorities identified by a roundtable of European experts convened by NEF (the New Economics Foundation) in December 2013.[19]

[19] With the support of the Friedrich Ebert Stiftung

Fairness and efficiency in economics

The discipline of economics has traditionally presented itself as separated from considerations of fairness and concerned instead with rational efficiency – meaning generally the maximisation of profit and gross domestic product. The question of how to ensure a fair distribution of resources or gains from prosperity is presented as a purely social and political question. It is true that fairness is a social rather than scientific construct, because it can mean different things to different people. For some a fair distribution is predominantly about notions of just rewards rather than relative equality. However, although fairness is a legitimately contested concept, it is not one that economists can ignore any longer. Economic inequality is increasingly recognised as one of the biggest challenges facing global and national economies.[20] It is not only concern about social justice and cohesion that means this is looming large in the public and political consciousness. Research is increasing our understanding that inequality played a critical role in the financial

[20] See for example, World Economic Forum (2014) Global Risks 2014, Ninth Edition. Geneva: World Economic Forum

crises of 2007/8 and prevents the achievement of healthy, stable economies.[21] This means that wealth distribution is an input to, and not just an output from, our economic system and that economics cannot reliably divorce questions of efficiency from fairness and proportionality.

Fairness and taxation

What does this mean for taxation? Despite growing evidence and anxiety about the damaging effects of high and accelerating levels of economic inequality within and between countries, there is as yet a serious policy gap in addressing it. One approach is to design our economic systems so that less unequal outcomes are produced in the first place[22] thereby reducing the burden on redistribution mechanisms. This is good in itself because it places less reliance on one set of instruments. However, reducing reliance on redistribution is important because taxation and welfare spending can be captured by powerful vested interests lobbying for tax and benefit reducing policies that weaken the effects of redistribution.[23]

Even if a more equal distribution of income and wealth could be achieved prior to taxation being applied (sometimes referred to as pre-distribution[24]), taxation still has a central role to play in deriving fair and efficient economic outcomes across the whole population and between economic sectors and regions. Taxation is therefore an important element of an interlocking policy agenda to tackle economic inequality at its root.[25]

The goal of taxation and its policy priorities

A roundtable of European experts convened by NEF in December 2013 to produce a policy agenda to tackle economic inequality defined an overarching goal for taxation as follows:

"a tax system which is progressive, fair and unavoidable and which supports productive activity and a fair distribution of economic power."

This goal has fairness at its core. It encompasses important principles. In the first place, the basic principle that those with greater economic and financial resources – who arguably benefit most from all that society and the economy has to offer – should contribute proportionately more back into society to support public finances. In the second place, our taxation system is an important mechanism for influencing incentives and the type of activity we pursue. This suggests taxing less socially valuable and outright damaging activities more heavily in order to discourage them and mitigate their impacts, and lightening the tax burden on more socially valuable activities and outcomes. Ultimately, design of taxation along these lines could increase the possibilities to reduce taxation on jobs and ordinary livelihoods – fundamental social goods.

[21] Kumhof, M. and Ranciere, R. (2010), *Inequality, Leverage and Crises*, IMF Working Papers 10/268, International Monetary Fund

[22] For example, so that there is less disparity between gross pay at the top and bottom of the distribution. See for example Hacker, J. Wednesday 12 June 2013. *How to re-invigorate the centre left? Predistribution.* Guardian Comment is Free. Retrieved from: http://www.guardian.co.uk/commentisfree/2013/jun/12/reinvigorate-centre-left-predistribution

[23] Stiglitz, J. (2012) The price of inequality. New York: W W Norton & Company Inc.

[24] Term coined by Labour Party leader Ed Miliband

[25] Kersley, H. and Shaheen, F. (2014) Addressing Inequality at Root: 5 steps for a fairer UK. London: NEF

In pursuit of this overall goal, and embedding the principles behind it, our experts identified four policy priorities:

1. minimise tax evasion and avoidance;
2. tax environmentally damaging activity;
3. achieve fair and progressive taxation; and
4. tax rent-seeking.

Fair play is at the core of the first priority. Minimising tax evasion and avoidance requires everyone to act in accordance with tax law and regulation regardless of status or income. Fair and equal treatment underpins the confidence of citizens in the tax system and therefore is vital to achieving high levels of compliance with tax law.

The second priority of taxing environmentally damaging activity can also be seen as relevant to fairness to the extent that environmental harm tends to fall unevenly on citizens within countries, and between countries within the global economy. Often it is the poorest and least advantaged who are most at risk from factors such as climate change and pollution.

With a view to the role of fairness in taxation the third and fourth priorities are particularly relevant and discussed in greater detail below.

Fair and progressive tax: Implementation of a coordinated system of progressive taxation of both income and wealth.

Recent polling suggests that 96% of the public would like to see a more progressive tax system than we have now.[26] The taxation system needs to work better to ensure that, across the board, the wealthier pay proportionately more as their incomes rise. This would help reduce growing disparities in incomes towards a fairer spread of disposable income, as is the case, for example in Denmark and Sweden where pre-tax incomes show wide differentials but post-tax income differentials are substantially narrowed.[27]

Achieving a more progressive system would mean combining an adequately tiered system of direct taxes on income, with an increase in rates at the top end. It would also mean paying attention to resolving the regressive nature of indirect taxation, which currently results in the least well-off households paying the greatest proportion of their income in tax.[28]

Experts at our roundtable discussion suggested first steps on a more progressive system with a rate of taxation on incomes above £50,000 set at 50% and progression in the marginal rate above that. It has been suggested that a top tax rate, on the top 1% of incomes, could be as high as 83% without impacting on productive activity.[29] The rationale is that capture of more income at the top does not reflect greater productive activity or addition to national income, but rather straightforward greed combined with the ability to exert imbalances of power within labour markets to extract increases in income far in excess of productivity gains. Taxing these incomes more sharply would reduce the incentives for the already rich to seek a bigger portion of the pie.

Tax rates up to 80% are not unthinkable; they were the rates applied even in the Anglo-Saxon economies of the USA and the UK until the 1970s. Evidence that taxing more progressively does not impact negatively on national income counters the narrative that higher taxes will dampen growth, and makes higher marginal

[26] Power, M. and Stacey, T. (2014) *Unfair and Unclear: the effects and perception of the UK tax system*. London: The Equality Trust

[27] *Lawlor, E., Spratt, S., Shaheen, F. (2012) Why the rich are getting richer: The determinants of economic inequality. London: NEF*

[28] Power, M. and Stacey, T. (2014) *Op cit.*

[29] Saez, E. and Picketty, T. (2013, 24 October). *Why the 1% should pay tax at 80%.* The Guardian. Retrieved from http://www.theguardian.com/commentisfree/2013/oct/24/1percent-pay-tax-rate-80percent

rates a legitimate option for policy-makers once again.

Clearly a more progressive taxation system relies on highly effective enforcement of tax compliance and fewer loopholes for tax avoidance because at higher rates the incentives for avoidance are likely to be greater.

Rent-seeking: Implementation of a land value tax.

Rent-seeking means deriving income without creating wealth. This can be possible from the grant of legal privilege over natural resources such as land, or from the ability to exploit imbalances of power within markets and institutions to grab a larger share of income without increasing income generation. Rent-seeking behaviour appears in different guises in different elements of the economy, for example, on a range of capital gains and financial transactions. One of the areas most highlighted is the unearned income enjoyed simply from owning land.

Taxing increases in value of unimproved land has been gaining interest in the UK and elsewhere. Ownership of land, separate from activity to improve it in some way, offers a rich source of gain to owners simply from the increase in the price of land. Churchill spoke about this compellingly over 100 years ago.[30]

"Roads are made, streets are made, services are improved, electric light turns night into day, water is brought from reservoirs a hundred miles off in the mountains – and all the while the landlord sits still. Every one of those improvements is effected by the labour and cost of other people and the taxpayers. To not one of those improvements does the land monopolist, as a land monopolist, contribute, and yet by every one of them the value of his land is enhanced."

According to an independent and thorough review into the tax system in the UK conducted in 2010, known as the Mirrlees Review[31]:

"The economic case for taxing land itself is very strong and there is a long history of arguments in favour of it. Taxing land ownership is equivalent to taxing an economic rent – to do so does not discourage any desirable activity."[32]

Contributions to public finances that are based on land value is arguably not even payment of a tax, and more to do with a payment for the unearned benefit of holding a share of the nation's land wealth. Approaches to land value taxation have been demonstrated in some countries – Denmark and Australia, for example. The economic benefit of a land value tax, over and above a potential source of funding for public services, is that is encourages productive land use, starting with the most valuable land in city centres. It serves to discourage speculative land hoarding at the same time as acting against urban sprawl and promoting greater care of natural resources.

Since land and property wealth is a major contributor to growing inequality in the UK and other countries, a system of land value taxation would directly address a critical aspect of the problem.[33]

[30] Monbiot, G. (2013, 21st January) *I agree with Churchill: let's get stuck into the real shirkers*. The Guardian. Retrieved from: http://www.theguardian.com/commentisfree/2013/jan/21/i-agree-with-churchill-shirkers-tax

[31] See Mirrlees, J., Adam, S., Besley, T., Blundell, R., Bond, S., Chote, R., Gammie, M., Johnson, P., Myles, G. and Poterba, J. (2011). *Tax by design*. Oxford: Oxford University Press

[32] Mirrlees, J. et al (2011) *Op cit.*

[33] Wightman, A. (2013) *A Land Value Tax for England: Fair, efficient, sustainable*. Retrieved from: http://www.andywightman.com/docs/LVT_england_final.pdf

Conclusion

It is increasingly recognised, from the perspective of inequality that the design of the taxation system is vulnerable to capture by wealthy elites who, having more resources at their disposal, hold strong lobbying power and have greater access to influence through networks. This has tended to strengthen the pressure for tax cuts and reduce the power of the redistributive system to tackle inequality.

Yet the arguments for using tax policy as part of an overall strategy to reduce economic inequality are compelling. Firstly, the overwhelming majority of citizens would like a more progressive tax system. Secondly, economic inequality undermines financial stability and the chronic economic recession in Europe that followed the financial crises from 2008 has shown how high the human, social and economic cost of financial instability can be. Thirdly, the explicit embedding of fairness as a key concept in developing tax policy is crucial for building and maintaining social cohesion and public confidence in the tax system. Finally, far from being a vital ingredient in stimulating economic growth, it is now increasingly understood that excessive economic inequality can be a key driver of recessionary pressure and undermine not just social progress, but economic progress too. A fair tax policy is therefore crucial to Europe's social and economic success.

The role of tax administrations in the current political climate

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Introduction

Over the last year there has been unprecedented attention focused on the role of tax administrations in delivering the revenues that governments need. Much of this attention has been on the question of whether or not multinational enterprises (MNEs) and high net wealth individuals (HNWIs) pay the right of amount of tax. There has also been a renewed interest in tax gap analysis. Yet, in many countries governments are cutting back on the resources available to tax administrations and, at the same time, asking them to do more, including the delivery of expenditure programmes. This article places this current political debate on tax evasion and avoidance in this broader perspective.

It suggests that, despite the current focus on adopting a tougher stance on tax enforcement, effective tax compliance will only be achieved is it is combined with good taxpayer service and where there is a constructive and transparent dialogue between tax authorities, taxpayers and their advisors. It also counters the impression that nations, such as the United Kingdom and the United States, have become nations of tax evaders. The reality is that the vast majority of taxpayers pay the right amount of tax, in the right place and at the right time.

In this respect, this article examines the following four related issues:

i. the change in attitudes to tax compliance on the part tax administrations;
ii. how tax administrations have responded to the challenges of operating a tax system in a rapidly changing global environment;
iii. what new challenges are tax administrations facing; and
iv. the role of international cooperation.

Change in attitudes on the part of tax administrations

In the latter half of the 20th century, the traditional approach of tax administrations to tax compliance was very much based on what I call a military analogy: identify the target (evaders), take them out. The focus was to detect and deter evasion primarily by blanket auditing. Tax administrations were the 'cops' in the system: their role was to police the system. Audits, usually confrontational, were at the centre of the strategy. Success was measured by the yield from these audits; the number of assessments made; the number of court cases won, or in some cases even lost; the extra revenue brought in. Most tax administrations were headed by either lawyers, with a natural inclination to litigate, or tax technicians that had worked their way up through the audit chain. Tax administrations found it relatively easy to gain more resources: most tax administrations were much larger in 2000 than they were in 1980.

Tax administrations are now moving towards developing a more behavioural response to compliance: shifting towards prevention rather than just detection and non-compliance. Why this change? The reasons include:

- recognition that the majority of taxpayers want to voluntarily comply and the tax administrations main task is to help them do that;
- taxpayers are becoming more assertive and insisting that they have rights as well as obligations;
- taxpayer segmentation, in the acceptance that different groups of taxpayers have different types of needs;
- a move away from a tax-by-tax approach to more of a taxpayer-by-taxpayer approach;
- most tax administrations, certainly in the developed world, are now under severe pressures to do more with less; and
- a recognition that the informal economy cannot be dealt with effectively just by stricter enforcement.

The pressures on tax administrations

Over the last three decades, the role of tax administrations has changed. Tax administrations have become not just collection agencies but also spending agencies. Many are now responsible for implementing social programmes, for example, family credits and student loan schemes. Many governments also look to the tax administration to implement part of their structural programmes to exit from the crisis. Increasingly, tax authorities are taking on the role of regulators, for example, in the environmental area.

All of this has changed fundamentally the way that a tax administration operates, the profile of the staff needed and the political risks for tax administrations. Few citizens complain if their tax bills are late, but they complain loudly if their benefits payments are late. Some tax commissioners are ambivalent about this trend and we are beginning to see a reversal, with some tax administrations curtailing their functions as spending agencies.

Tax administrations now have to live in a global environment where MNEs operate as global entities, with increasingly tenuous links to their own countries. They operate and plan on a global basis and this applies to their tax affairs. Similarly, the advisory profession has become increasingly global. Nowhere is this process of globalisation stronger than in the financial sector. Foreign exchange controls have largely disappeared; controls on inward and outward investment have gone. Technology has enabled

financial institutions to move vast sums of money around the world at the click of a mouse. Despite the challenges globalisation poses for tax administrations, one should not underestimate its benefits: for citizens; for governments; for business. But we must make sure that the costs and benefits of globalisation are fairly shared.

This globalisation of national economies poses new challenges for tax administrations, as they have to operate behind national barriers.

Another transformation in the global environment is the growth of new types of HNWIs. We have always had the very rich, but what we are now seeing is a tendency to move towards what some investment bankers have called the ultra-rich; or what many call, "Davos men," and, generally, they are men rather than women. These are individuals who have much weaker ties to any jurisdiction; who are more aggressive and hands on in managing their wealth. And who are more footloose and more at ease with each other than their fellow citizens. They are also prepared to take more risks in their management of their portfolios, including in their tax planning.

We have also seen governments putting more pressure on tax administrations to reduce compliance costs for taxpayers. This is not new, but it has taken on a new dimension with the recognition that compliance costs can be a factor in defining the competitiveness of a country.

This new environment has, nevertheless, opened up new opportunities for tax administrations:

- new technologies which enable tax administrations to provide e-services to a wider range of taxpayers;
- software that makes it far easier for tax administrations and taxpayers to calculate the amount of tax due;
- acceptance that in a global economy there is a need for greater tax transparency and the elimination of bank secrecy as a shield behind which tax evaders can hide; and
- new opportunities for tax administrations to learn from the experiences of each other and to intensify their cooperation and coordination.

How have tax administrations responded to these pressures?

Introductory remarks

Tax administrations today are very different organisations to what they were even ten years ago. Some of the major changes are considered below.

Structural changes

Tax administrations have moved away from a tax-by-tax approach to an integrated approach to dealing with the taxpayers. Today, there are very few OECD member countries that have not integrated direct and indirect tax departments and many have also brought in social security. For large taxpayers, we increasingly see that VAT, corporate income tax and other taxes are dealt with in a highly integrated approach, with many countries having relationship managers that are dedicated to a particularly large company. We have also seen the move towards the creation of independent revenue services, especially in non-OECD countries, and this has minimised political influence, encouraged a move towards a more realistic pay scale and also made a clearer distinction between policy formulation and policy implementation.

In addition, we have seen most tax administrations establish special units to deal with groups of taxpayers which are particularly important in terms of revenue contribution.

Many tax administrations now have large business units and these are generally responsible for dealing with MNEs. A growing number of countries have created units which focus on HNWIs and some have specialised units to deal with small and medium-sized enterprises (SMEs). We can expect this to tendency towards taxpayer segmentation to continue.

A new emphasis on risk management

Increasingly tax administrations are adopting a more sophisticated approach to risk management, which can be seen as part of the segmentation approach. The basic idea is simple: by focussing resources on higher risk segments and taxpayers, tax administrations can make a more effective use of their limited resources. This requires a systematic approach to the identification, assessment, prioritisation and treatment of compliance risks.

Successful risk management requires:

- better access to information both domestically and offshore, and information that is needed to identify both low and high risk taxpayers;
- this, in turn, requires the ability to integrate information from different sources; and
- a communication strategy, explaining why a taxpayer is in the high risk category, what are the criteria, and what are the consequences.

A more behavioural approach towards compliance

This approach recognises that the taxpayers' attitudes towards compliance are more complex than just being driven by the fear of detection. Behavioural scientists and economists have developed a new approach, largely pioneered by the Australian Tax Office (ATO), which was far-sighted enough to support academics undertaking research in this area. The key idea is that those taxpayers who want to comply should be helped to do so, whereas the persistent evaders should be targeted for investigations and subject to strict penalties.

The ATO developed a compliance pyramid that placed taxpayers into the following four categories:

(1) those who do not wish to comply;
(2) those who do not comply, but will do so if the tax administration focuses on them;
(3) those that try to comply but do not always succeed; and
(4) those that are willing to do the right thing and end up doing so.

This model went on to identify the five factors that may influence taxpayer behaviour:

(1) the business type, i.e. sole trader, MNE, etc.;
(2) the industrial sector, for example, whether or not the sector is heavily regulated;
(3) the economic environment, i.e. what the macro economic situation is like;
(4) the psychology of the taxpayer, i.e. fear, concepts of fairness, etc.; and
(5) sociological factors.

The implications of this new approach are that it generally enriches the tools available to tax administrations to achieve good compliance that go way beyond just enforcement. It encourages them to educate taxpayers on their rights and obligations; to put in place mechanisms to improve service; and to move towards a more targeted enforcement approach.

Putting tax compliance in the broader governance and/or social responsibility framework

For far too long tax administrators only talked to tax professionals, whether in the advisory community or in business. This is changing. Commissioners are now spending more time talking to Chief Executive Officers (CEOs), Chief Financial Officers (CFOs), Audit Committees and corporate boards. Getting them to see that good tax compliance should be part of their good corporate governance strategy is not easy when the financial crisis is putting pressure on corporations.

The attractiveness of this approach is that it forces corporate boards to discuss more frequently tax issues and to take ownership of a company's tax strategy. Boards are more likely than tax directors to weigh up the financial and reputational risks associated with an aggressive tax strategy against a potential saving in tax. Some boards may decide to continue to pursue an aggressive strategy, others may not, but at least the debate goes beyond just minimising the effective tax rate.

When the OECD started to explore this new approach in its Forum of Tax Administration (FTA), many tax commissioners were sceptical. Some countries had rules that forbid the commissioner to go into a boardroom; some commissioners were concerned about being accused of doing, "sweet deals." And some felt that this was not part of their job description.

Not unexpectedly, there was also reluctance on the part of the business community and the advisory profession. They argued that tax was just too complex to have the board engage in detailed discussion.

The corporate governance community, as represented in the OECD's Corporate Governance Group, was reluctant to make the link between good corporate governance and good tax compliance. But after five years of work by the FTA, things are changing. Increasingly, commissioners are spending more time talking to board members and this has resulted in a move towards boards accepting they must respect both the letter and the spirit of the tax laws. A view reinforced by the recently revised OECD Guidelines on Multinational Enterprises,[34] which now explicitly refers to the need for MNEs to respect the spirit and the letter of the law.

This message has also been reinforced by the way in which civil society has taken up the issue of tax transparency and good tax compliance. And governments, both of the left and the right, have been responsive to these campaigns (the effect of the 'Occupy Wall Street' and 'Tax uncut' campaigns cannot be overestimated). Tax commissioners and tax directors need to reflect on how they can operate in this new, more politically inclusive environment.

[34] OECD, Guidelines on Multinational Enterprises (OECD 2011), available at www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/oecdguidelinesformultinationalenterprises.htm.

The move to more tax transparency

Tax administrations have built on the political support from the G20 and other groups towards more transparency in taxation and the elimination of bank secrecy as a shield behind which tax evaders can hide. Tax administrations are putting in place voluntary compliance initiatives to encourage taxpayers to come forward and declare their assets held illegally offshore. Other countries are putting in place tax amnesties. Some countries now require taxpayers to disclose uncertain tax positions. All of these initiatives recognise that we must deal with the legacy of the past if we are to move on to a new, more, cooperative future.

We have also seen a tougher approach adopted towards aggressive tax planning. Many governments have put in disclosure rules. Others have targeted not just the users of the schemes but also the promoters and many countries are using sophisticated communication campaigns to show why it is socially unacceptable to engage in these types of practises.

Upcoming challenges

In the context of the current media and political campaign to counter tax evasion and aggressive avoidance, tax administrations will come under unprecedented pressure to adopt a tougher approach to non-compliance. How effective they are in responding to these pressures will, in part, depend on how effective governments are in dealing with some of the broader challenges that will face tax administrations over the coming decade. What are these upcoming challenges? There are many which will materialise, but I will identify the following nine that may be particularly problematic:

(1) *The risks of breaches of confidentiality*. While welcoming the spread of tax information exchange agreements, whether bilateral or multilateral, and the move towards automatic exchange, it is clear that in this new environment there is a risk that information will be leaked which could jeopardise the move to better exchange of information.

(2) *The increasing role of medium-sized enterprises in cross-border trade* will also challenge tax administrations. These enterprises are far less familiar with the international tax rules and, therefore, may find themselves in a situation of non-compliance, in part, because they are not familiar with the rules. Tax administrations will need to consider how they can actually help these taxpayers, particularly in the area of transfer pricing.

(3) *Working closely with other enforcement agencies*. Tax administrations need to accept they have a role in counteracting all forms of illicit activities and that information shared with other government departments does not represent a breach of confidentiality. There has been significant progress here over the last 18 months with the Financial Action Task Force making tax crimes a predicate offence. We have also seen unprecedented cooperation between tax and other law enforcement agencies but again, this does pose risks for tax administrations and does change the nature of their work.

(4) *The emergence on the global scene of MNEs that are from the BRICS* (Brazil, Russia, India, China and South Africa) and other economies in transition. Since 2006, the Boston Consulting Group has been producing an annual list of 'global challengers' from emerging economies. In 2006, its top 100 challengers were dominated by 84 large companies from the BRICS, with 34 being China-based. By 2013, the number of companies from the economies in transition other than BRICS had increased from ten to seventeen and there was a much broader range of activities carried out by these companies with the emergence of high tech and more consumer orientated groups. These new global challengers are buying up firms in OECD member countries as a way of acquiring new skills and entering new markets and are particularity strong in developing markets, for example, Chinese contractors now account for 37% of the African construction market.

They are also making a significant contribution to OECD economies, for example, TATA, the Indian conglomerate, now employs 45,000 individuals in the United Kingdom. These examples show how non-OECD-based MNE have begun to go global and are now some of the fastest growing MNEs in the world. Inevitably, they have less familiarity with the international rules of the game whether in the area of treaties or transfer pricing and, therefore, perhaps may inadvertently or consciously non-comply with these rules; some may have weak corporate governance cultures.

(5) *Pressure to produce a business-friendly tax environment*. We can expect this pressure to increase as governments recognise that a competitive tax environment is not just a question of putting in place the right policy environment, but it is also a question of how the rules are administered in practice. The challenge for tax administrations is to avoid that a business-friendly tax environment becomes an excuse for weak tax compliance as a means of attracting business.

(6) *Recruiting and maintaining high quality staff.* A tax administration is only as good as its staff. Yet, today we see many tax administrations with an aging workforce facing the risk of a generation gap. Morale is weak and training programmes are being cut. A worldwide shortage in qualified tax professionals is emerging and governments will find themselves competing with the private sector for this diminished pool. One response may be to adopt more of a revolving door policy, whereby it becomes acceptable for tax experts to move freely between the private and the public sectors.

(7) *Maintaining taxpayers' trust in the system.* A tax system is only as good as it is perceived to be. There must be a relationship between taxpayers, tax advisors and tax administrations that is based on trust; a mutual understanding. An inclusive and constructive dialogue on issues is the most effective way of preventing that these issues become problems.

(8) *Outsourcing of functions.* Already we have seen many administrations undertake a substantial outsourcing of information technology (IT) functions, but there are also other functions that are being outsourced. Financial institutions are being asked or required to play a more important role, not just in the collection of tax (the traditional role of withholding agencies), but also as assessors of tax due and verifiers that the tax obligations are met. You can see this

with the US qualifying investments (QI) arrangements and with the US Foreign Account Tax Compliance Act (FATCA),[35] initiatives. You can also see it in the Rubik agreements that are being pushed by Switzerland.[36] In addition, we are seeing the beginning of a process by which tax authority's role as the collectors of data becomes less important as they rely on the information stored in the cloud.

(9) *Attitudes are changing towards tax disputes.* Today, tax administrations and taxpayers increasingly recognise that they have a shared interest in minimising and resolving quickly tax disputes and a recognition that this requires focusing not just on one particular issue, but on the whole process by which they can avoid disputes. This requires engaging taxpayers in the process of policy formulation and implementation. It requires identifying and discussing issues before they become problems. It requires pre-filing resolution, the type of programmes that we see in the United States (the compliance assurance program (CAP)) or the Netherlands horizontal monitoring programmes.[37] It also requires a greater use of informal mediation, particularly in the area of establishing the facts in transfer pricing cases. And it requires a wider use of advance pricing agreement (APA) type of programmes and mandatory arbitration. All of this will require a new type of commitment from tax administrations and willingness to devote scarce and highly trained officials to resolve tax disputes.

[35] US: Foreign Account Tax Compliance Act. This Act represents US: Internal Revenue Code of 1986 (IRC), chapter 4 and was introduced as an amendment of 18 Mar. 2010, enacted as Title V of Public Law 111-147 or the Hiring Incentives to Restore Employment Act.

[36]. For a critical view of Rubik agreements, *see* P. Pistone, *Exchange of Information and Rubik Agreements: the Perspective of an EU Academic*, 67 Bull. Intl. Taxn 4-5 (2013), Journal IBFD.

[37]. For more on the latter, *see* L. van der Hel-van Dijk & M. Pheijffer, *A Tailor-Made Approach to Fiscal Supervision: An Evaluation of Horizontal Monitoring*, 66 Bull. Intl. Taxn. 10 (2012), Journals IBFD.

The role of increased international tax cooperation

Better cooperation between tax administrations can help to resolve some of these challenges. Many of these challenges come about from the intensification of the process of globalisation and that in turn requires an increased cooperation between tax administrations. We have to accept that this will be a messy process with different actors playing different roles. Those who advocate that the solution to this is to create a UN-styled body, a kind of World Tax Organisation have to recognise that whilst, in abstract, this may be desirable, in practice it is a political non-starter.

We will continue to have many actors on the scene, regional groupings (the Intra-European Organisation of Tax Administrations (IOTA), the European Union, the African Tax Administration Forum (ATAF) and the Centre for Inter-American Tax Administrators (CIAT), The Commonwealth Association of Tax Administrators (CATA); smaller groupings (the BRICS)), and more global groupings like the FTA, the UN Tax Committee and the Global Forum on Tax Transparency (at the last count, there were more than 15 organisations working on tax administrations around the world). In an ideal world, these organisations would come together under an umbrella organisation (an approach that I tried with the creation of the Committee of International Organisations of Tax Administrations (CIOTA) in the 1990s, but which failed, although the International Tax Dialogue does bring together many of these organisations and has the potential to play this role). Nevertheless, we need much closer cooperation

between these organisations. We need a sharing of best practices and global benchmarks for the performance of tax administrations. This requires a South-South as well as North-South dialogue.

We also need to move from cooperation towards better coordination between tax administrations: moving beyond the exchange of information, having simultaneous examinations, joint audits all of which offer new and exciting opportunities for coordination. The legal framework is there in the Multilateral Convention on Administrative Assistance, which now has over 70 signatories. We also need more effective mechanisms to share information on aggressive tax planning schemes. So yes, tax administrations will remain national, but they can overcome these geographic barriers by better cooperation and better coordination.

Finally, for tax administration to effectively implement the tax laws and to ensure that MNEs and other taxpayers pay the right amount of tax, in the right jurisdiction and at the right time, requires that governments provide a clear legal framework and the resources they need to achieve this. It also requires a coordinated approach by governments to review the existing international tax arrangements to ensure that the division of the tax base between countries reflects the economic contribution that each part of an MNE has made to global profits of an MNE and it requires a common understanding on what constitutes fair and unfair tax competition. Hopefully, when G20 Leaders meet in Turkey in November 2015 to finalise the base erosion and profit shifting (BEPS) recommendations they will provide this new framework.

The role of European banks as reporting financial institutions in international tax compliance

Roger Kaiser joined the European Banking Federation (EBF) in 1999 after serving the Belgian Internal Revenue Service for seven years, notably as head of the taxation unit for Brussels' tax intermediaries and as adviser to the directorate-general for corporate income tax and withholding tax.

In his current capacity as Senior Policy Adviser to the EBF, he represents European banks in a number of international expert groups including the Commission's Expert Group on Automatic Exchange of Financial Account Information, the Tax Committee of the Business & Industry Advisory Committee to the OECD and the Tax Working Group of the International Banking Federation. He has a Master's Degree in Business Engineering, a Master's Degree in Taxation and a Post-Graduate Degree in European Tax Law. He is a member of the Belgian Institute of Chartered Accountants and Tax Advisers.

Introduction[38]

The perception of the role of banks by public authorities, in particular by tax administrations, quite significantly diverges from the perception that bankers have of their own role, which consists of making loans available to households and businesses and of securely handling payment transactions.

Over the last decade European banks have been requested by tax authorities to play an increasing role as tax intermediaries, which consists of collecting withholding taxes and of disclosing information about investors. With the forthcoming implementation of the Common Reporting Standard (CRS) and the revised Directive on Administrative Cooperation (DAC2) this role will be further developed in the near future. Banks will then be required to systematically report information on their foreign customers and are making huge investments in systems' upgrades and procedures' adaptations in order to be compliant with the new requirements. In an international context, banking secrecy, which according to recent journalistic investigations may have facilitated tax evasion, is becoming past history.

This article provides explanations of the tax procedures banks will soon have to implement in order to be CRS-compliant. Against this background, it highlights a number of implementation challenges that lie ahead of banks. It questions whether these efforts and the introduction of increasingly demanding tax compliance requirements are the right approach to combat tax fraud and whether they are economically sustainable in the long run.

[38] The European Banking Federation (EBF) is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2,5 million people. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth. Website: www.ebf-fbe.eu

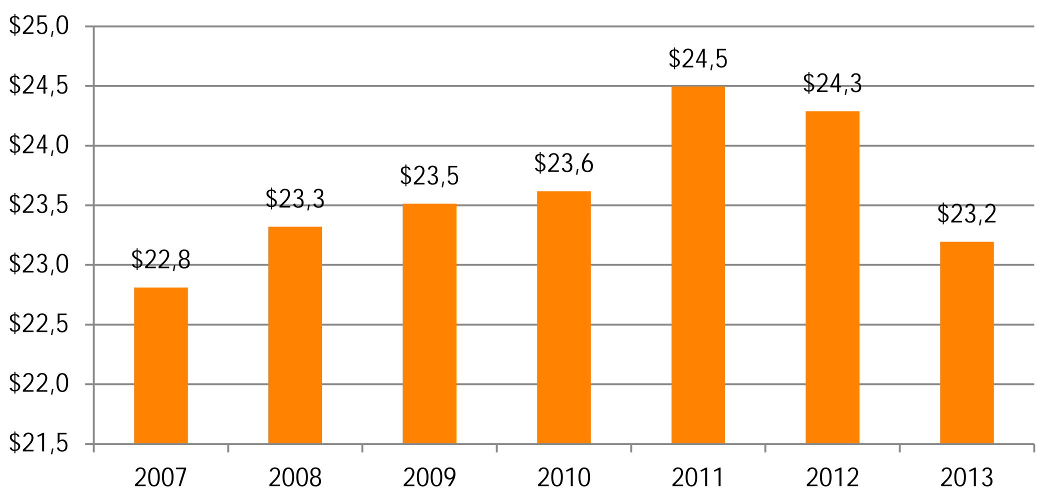
Overview of the role of banks in Europe

The essential functions of banks

The definition of banks is not provided by EU law, which only defines the more restricted concept of credit institutions. In domestic law, the definition of banks varies quite significantly from one Member State to another. Overall, a bank can nonetheless be defined as a legal entity which carries out traditional banking activities consisting of managing, transforming and absorbing financial risks, and which provides intermediation services and payment facilities.
The core business of commercial and retail banks consists of taking short-term deposits from customers and of granting long-term credits, loans and mortgages. In this respect, banks have to comply with strict regulatory capital requirements. The profitability of retail banks is derived from the 'yield curve', i.e. it depends on their ability to generate a spread between the long-term interest rates they apply to borrowers (on their assets) and the short-term interest rates they offer to a pool of savers (on their liabilities). This process is known as maturity transformation. To a large extent, commercial banks' profits depend on their efficiency in managing liquidity risk, market risk and credit risk, which requires them to carefully assess the credit worthiness of borrowers.

Banks play a crucial role in fuelling the economy by lending to households, governments and businesses and by managing payments. In 2013, EU banks financed EUR 23.2 trillion in loans. Between 2008 and 2013, loans to households for house purchases grew by 12.6% and to governments by 15%. Loans to business fell by 9%.

FIG. 1: Total bank loans in EU27 (€ trln)

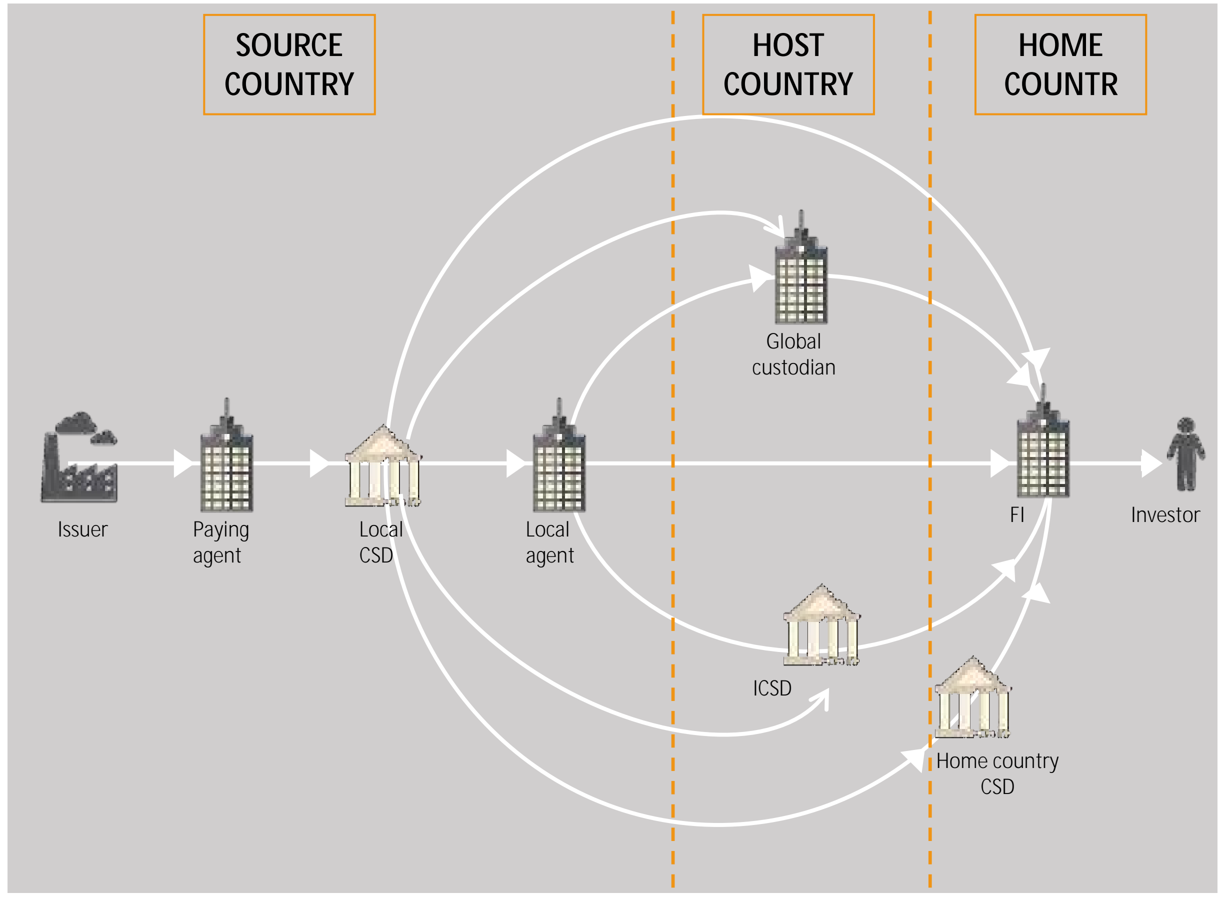


In the universal banking model, which has been challenged in the aftermath of the financial and economic crisis, banks complement traditional deposits as a source of funding by directly borrowing money on capital markets by issuing securities such as equity, bonds and commercial paper. Investment banks are those which specialise in underwriting securities on behalf of corporate clients, helping them raise funds, making markets for their securities and giving them advice on mergers and acquisitions. Other related banking activities undertaken by large

banks include corporate banking, private banking and trading activities on money, foreign exchange and derivatives markets.

As a complement to the taking of deposits from customers, retail banks act as paying agents, issue debit and credit cards and arrange wire transfers with other institutions. To complement the activities they carry out on financial markets, banks can also be involved in custodial and fiduciary activities which mainly consist of safekeeping financial assets (securities) for their clients, collecting and processing income payments, dealing with the settlement of securities transactions (post-trading) and exercising the share ownership rights. Some large banks, which are referred to as global custodians, specialise in custodial and fiduciary activities and exercise them in multiple jurisdictions through a global network of branches and other local custodians. In such cases, securities are held on a fungible basis through multiple tiers of custodians, Central Securities Depositories (CSD) and other financial intermediaries (e.g. in omnibus accounts). According to fiduciary arrangements, each custodian of such a registration chain is registered as the holder of the securities, the ultimate security holder remaining the legal owner. The flowchart below shows that in order to access a foreign market or to make cross-border securities transactions, investors and intermediaries may use the services of a global custodian or an International CSD which will access the local CSD either directly or indirectly (through the registration chain). Alternatively, investors and intermediaries may themselves directly access the local CSD or use the services of a local agent who is a member of the local CSD. As a result the payment chain may adopt various profiles.

FIG. 2: Payment chain related to a cross-border portfolio investment



The role of banks in international tax compliance

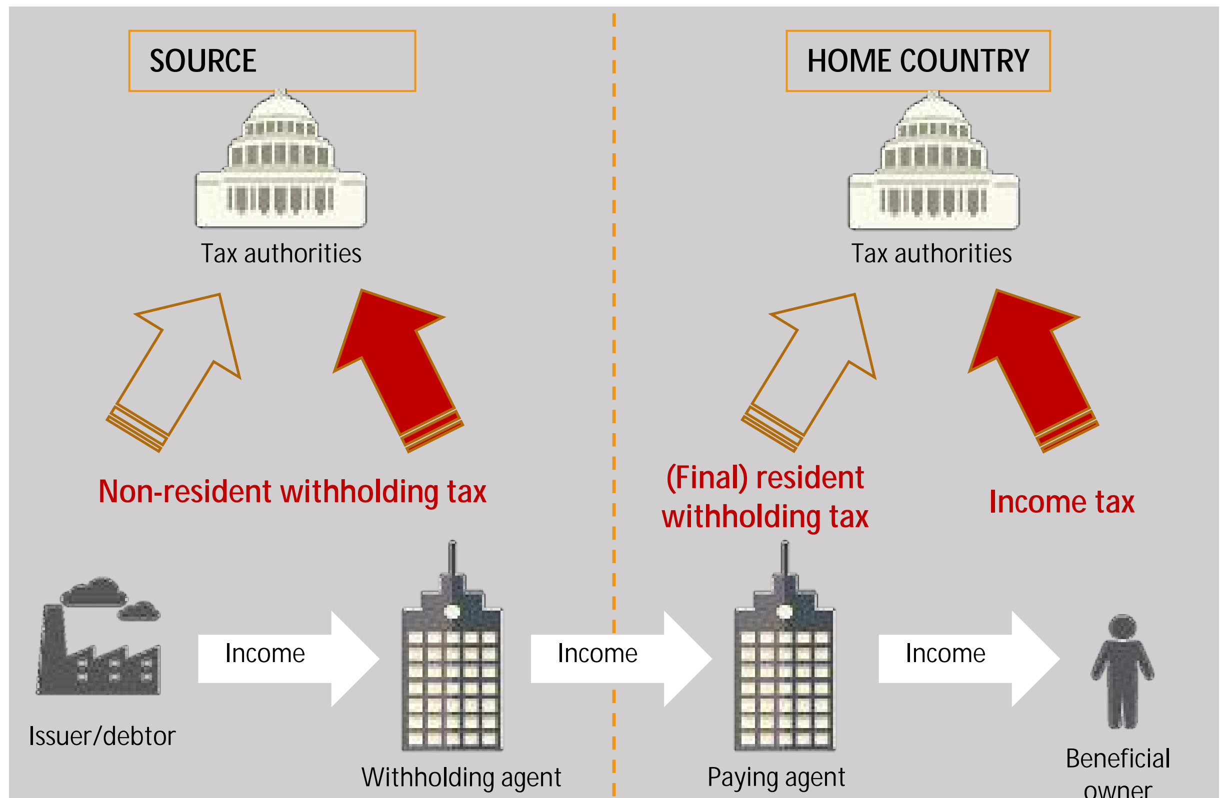
Banking activities have evolved over time and have been adapted to the specific needs and requirements of an ever-changing environment, crossing through the successive waves of mass banking, complex products, universal banking, and more "market solutions", self-banking, e-banking, shadow banking, etc.

The level of intervention of the public sector in banks has also significantly varied in history. For ages, banks have been used as direct and indirect instruments of public policy, notably as transmission channels for monetary policy. There are many examples of extreme situations of public intervention including massive bank nationalisations, intervention of banks in geopolitical conflicts and in the fight against money laundering, crime and terrorism.

The involvement of banks in tax processes, which mainly results from their activities as paying agents and custodians, has dramatically increased over the last few years and is about to enter a new era.

To understand these developments, it is necessary to look at the OECD's model bilateral tax treaty, according to which the country of residence of a payee who receives an investment income payment from a debtor situated in another contracting state (the source country) has full taxation rights on this income, while the source country can only deduct a withholding tax at a reduced rate (fixed by the bilateral treaty), i.e. a tax rate which is generally lower than the tax rate applicable to resident taxpayers and can even be reduced to zero.

FIG. 3: Withholding and income taxes deducted along a payment chain involving two jurisdictions



The beneficial owner of such income is required to declare it in a tax return he/she has to file in his/her country of residence, unless a final resident withholding tax has been deducted in this jurisdiction. In this latter case, the national tax law requires local financial institutions (FIs) intervening in the income payment to deduct a resident withholding tax, which is final; the investor is not required to declare it and is not entitled to a related tax credit. Instead of requiring FIs to deduct a withholding tax on income payments made to resident taxpayers, some jurisdictions impose domestic reporting requirements on their FIs.

In the source country, the domestic tax law provides for the collection of a non-resident withholding tax and for relief procedures, which enable foreign investors to benefit from a reduced tax rate or an exemption. Debtors and FIs intervening in such payments may be required by the domestic law to act as withholding agents, i.e. to deduct a domestic non-resident withholding tax and to pass the related investor information up the chain.

Over the last 15 years, a new trend has emerged in international tax law which departs from the traditionally polarised approach where income payments are only considered from the perspective of the source country and the country of residence. This approach imposes compliance requirements on FIs established in another jurisdiction than the source and residence countries: the host country. The reason for such change primarily lies in the fight against tax fraud and offshore tax abuses which have become a major concern for governments and tax authorities within the EU and worldwide. In the wave and aftermath of the economic and financial crisis, it has been exacerbated by the tax consolidation efforts that governments have been forced to undertake. In order to replenish public finance, governments are focusing on Automatic Exchange of Information (AEOI) in order to ensure effective taxation of income paid to their resident taxpayers via offshore accounts. Tax evasion and tax avoidance have also been put in the limelight by titanic journalistic investigations without historical precedent.

FIG. 4: Tax compliance requirements along a payment chain involving multiple jurisdictions

SOURCE COUNTRY
Tax authorities
Non-resident withholding tax
Issuer/debtor
Income
Withholding agent

HOST COUNTRY
Tax authorities
Automatic reporting
Treaty-relief documentation
Income
Financial Intermediary
Income

HOME COUNTRY
Tax authorities
Income tax
Investor

Banks in cross-border portfolio tax processes

Depending on the domestic law, the primary non-resident withholding responsibility – i.e. the withholding agent status - may lie with different persons and intermediaries established in the source country. In a large number of EU Member States the withholding responsibility exclusively lies with the issuer of the securities, but in some Member States it may also be the responsibility of the paying agent, i.e. the intermediary involved in the income payment. Under the standard procedure, relief from withholding tax is obtained through refund of withholding tax, which is directly requested from the source country's tax authorities by the withholding agent who needs to obtain preliminarily certificates of tax residency per investor. The complexity and cost of obtaining the tax relief to which an investor is legally entitled often leads investors to forego the relief. Full withholding at the maximum tax rate is then the outcome.

Since 2000, QIAs govern treaty relief procedures applicable to US-sourced income payments. Non-US FIs can preliminarily enter into a QIA with the US Internal Revenue Service (IRS), according to which income payments are made immediately taking into account the exemptions or applicable reduced rates. Investors have to provide a properly-completed standardised Investor Self Declaration (ISD) to the qualified intermediary (QI), which is then required to pass on investor-specific information on a pooled basis (information by withholding rate pools) along the payment chain up to the source country. This regime abolishes the need to obtain certificates of tax residency per investor and there is no requirement to pass upstream confidential investor information. In this regime,

QIs may opt for a withholding-QI status and assume primary withholding responsibility.

In 2001, the first Giovannini Report identified 15 barriers associated with the clearing and settlement of cross-border securities transactions within the European Union. Two of these barriers relate to taxation. Barrier 11 stipulates that foreign intermediaries cannot offer withholding tax relief at source or only under the condition that they have a fiscal agent. In 2009, the European Commission adopted a Recommendation on Witholding Tax Procedures[39] proposing the implementation of streamlined treaty relief procedures.

In the same vein, the OECD has developed the TRACE Implementation Package (IP). This model suggests that FIs can enter into Authorised Intermediary (AI) agreements with the tax authorities of the source country. In their capacity as AIs, they can then claim withholding tax relief on behalf of customers on a pooled basis. Investors have to provide a properly completed standardised Investor Self Declaration (ISD) to the AI, which is then required to report investor-specific information to the source country[40]. This regime would abolish the need to obtain certificates of tax residency per investor and there would be no requirements to pass confidential investor information upstream. The TRACE IP includes an application for an FI to request authorisation from source countries to act as an AI and includes a sample contract that could be used between the source country and the FI. The investor self-declaration forms would enable the investor to benefit from tax relief at source under the regime when presented to a participating AI.

[39] COM(2009)7924 final Commission Recommendation of 19.10.2009 on withholding tax relief procedures.

[40] This is followed by an information exchange to the attention of the tax authorities of the country where the investor is resident for tax purposes.

The Commission's Tax Barriers Business Advisory Group (T-BAG), which had been set up in 2010 with the aim to consider the follow-up to the Commission's Recommendation on Withholding Tax Procedures from a business perspective, and to identify any remaining fiscal barriers affecting the post-trading environment, released a report in 2013 in which it suggested that the TRACE approach be implemented in EU Member States.

Banks in the Automatic Exchange of Information framework

OECD developments during the pre-FATCA era

Automatic exchange of information (AEOI) stands for mandatory information exchange from the host country to the country of residence of the investor or account holder. In the AEOI framework, information exchanged does not have the same destination as in treaty relief procedures where investor information is passed on to the source country.

There will be two eras in the history of AEOI: a pre-FATCA era and a FATCA era or post-FATCA era. In the pre-FATCA era, the OECD made only timid steps in the field of information exchange:

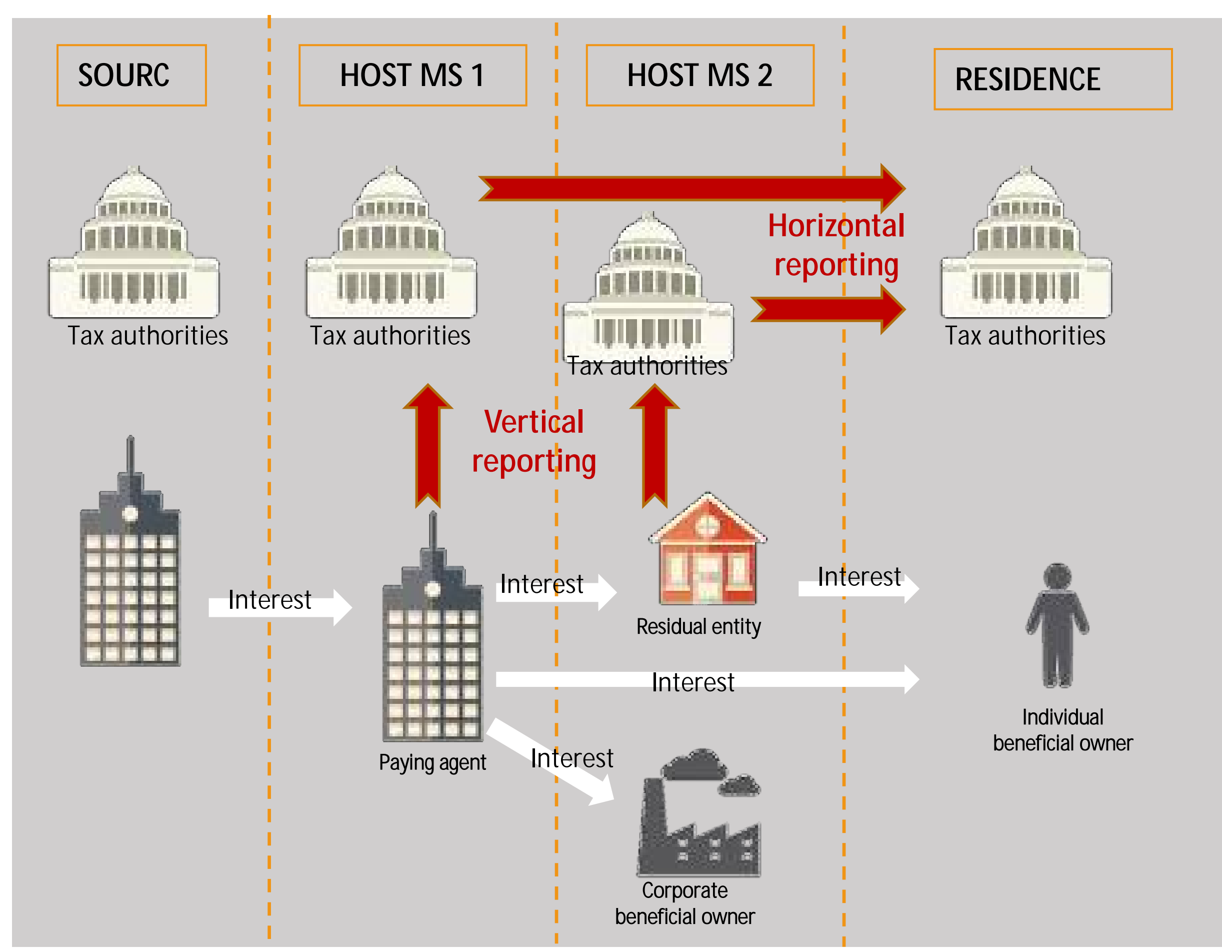
- the adoption of a Model Agreement on exchange of information upon request; and
- the development of a legal framework to facilitate bilateral agreements on AEOI in which reporting however remained a by-product of domestic reporting.

In 2011, the OECD decided to tackle tax evasion as a priority issue and to develop a model for a global AEOI.

The EU Savings Tax Directive – A first experience of Automatic Exchange of Information

The EU Savings Tax Directive (EUSD), which was adopted in June 2003 and has been implemented since July 2005, is the first real-life experience of cross-border AEOI. The directive, whose scope encompasses intra-community interest payments, is aimed at ensuring effective taxation of interest payments received by individuals who have their residence in Member State other than the Member State where the paying agent making the payment is established. It provides for a coexistence model combining a withholding tax system and a reporting mechanism, which is indirect, i.e. whereby FIs (paying agents) are required to report information to their tax authorities (vertical reporting) which exchange this information with the tax authorities of the country of residence (horizontal reporting).

FIG. 5: Reporting mechanisms under the EU Savings Tax Directive



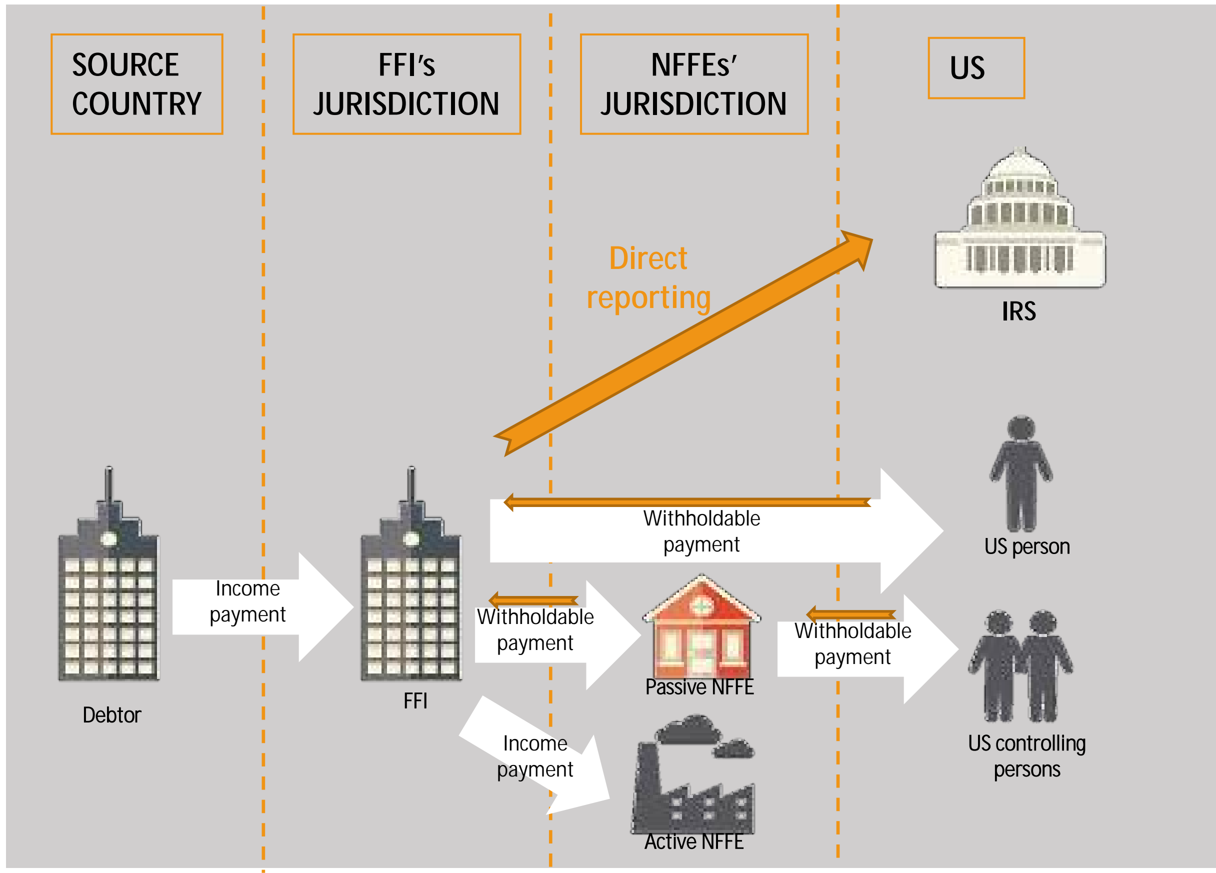
In March 2014 the ECOFIN Council adopted a revised version of the EUSD, on the basis of a legislative proposal made by the Commission in November 2008 as a result of its first review of the functioning of the directive, with a view to closing existing loopholes and better preventing tax evasion. However, the EUSD will be soon superseded by the Common Reporting Standard (CRS) developed by the OECD at the request of the G20. In this context, the CRS will be implemented in the EU based on an amended version of the Directive on Administrative Cooperation (DAC2), while the EUSD is very likely to be soon repealed, as strongly advocated by the European Banking Federation.

FATCA: A catalyst for a global approach to Automatic Exchange of Information

In 2010, which was a turning point in the history of AEOI, the US enacted FATCA, which stands for Foreign Account Tax Compliance Act, to unilaterally impose worldwide reporting obligations on FIs within a contractual framework, i.e. based on agreements between FIs and the Internal Revenue Service. FATCA is aimed at tracking US taxpayers (US persons) who could evade tax obligations in their 'home country' either through offshore bank accounts held with Foreign Financial Institutions (FFIs) or through investments in Non-Financial Foreign Entities (NFFEs) i.e. shell corporations set-up outside the USA. The first implementation phase of FATCA started on the 1 July 2014.

In order to force FFIs and NFFEs to comply with FATCA due diligence and reporting requirements, the FATCA legislation takes a Manichean view between 'good' FFIs (i.e. participating FFIs known as PFFIs) and 'bad' FFIs (i.e. non-participating FFIs – NPFFIs) and between 'good' NFFES (compliant NFFEs) and 'bad' NFFEs (non-compliant NFFEs). FATCA uses a withholding mechanism as coercion. It consists of a penalising 30% withholding tax, which is triggered and applied on withholdable payments made by upstream FIs (withholding agents) to recipients that are NPFFIs or non-compliant NFFEs. In addition, a distinction is drawn between active NFFEs (those engaged in an active business) and passive NFFEs.

FIG. 6: Reporting mechanisms under FATCA Regulations



Participating FFIs[41] have to comply with the following requirements:

- Identification in the client base of all direct and indirect US accounts (i.e. held directly or through NFFEs) and look-through for NFFEs to determine whether there are US controlling persons in these entities;
- Prescriptive verification criteria and due diligence procedures with respect to the identification of US accounts;
- Disclosure to IRS of the identity of US accounts and of US controlling persons of passive NFFEs;
- Annual report to IRS including all income (US and non-US) paid to US persons and to US controlling persons of passive NFFEs;
- Request from any US account holder of a waiver from privacy or bank secrecy law and closing of accounts of recalcitrant account holders (i.e. undocumented and uncooperative customers);
- FATCA withholding on all payments to non-participating FFIs, non-compliant NFFEs, recalcitrant account holders and FFIs that have elected to be withheld upon rather than to withhold.

[41] A FFI is defined as a foreign entity that accepts deposits in the ordinary course of business, is in the business of holding financial assets for others, or is primarily engaged in the business of investing, reinvesting or trading in securities, partnership interests, commodities. FFIs include hedge funds, private equity funds, other collective investment vehicles (CIVs), insurance companies and holding companies of FFIs. Participating FFIs (PFFIs) are those FFIs which have signed a FFI agreement with IRS or have registered with partner country authorities. Are deemed compliant FFIs (DCFFIs) certain FFIs including FFIs with small number of owners, certain local banks and certain qualified investment vehicles with local activities, provided that they have registered with IRS or are self-certified. Are exempted FFIs those FFIs mentioned on the statutory list of low-risk entity types: holding companies, start-ups, entities that are liquidating/reorganizing, hedging financial centers, insurance companies not issuing cash value products and DCFFIs. Each FFI affiliate of an expanded affiliated group (entities which are more than 50% owned by the same parent) must satisfy the requirements of a PFFI or a DCFFI.

US-owned NFFEs[42] which are not engaged in an active business (passive NFFEs) have to disclose the US controlling persons by providing name, address and Tax Identification Number (TIN) to Participating FFIs which report to IRS the share of the income attributed to US controlling persons. Non-US owned (passive) NFFEs have to provide upstream a certification that they do not have US controlling persons.

Inter-Governmental Agreements

Governments in third countries, in particular in the EU's five largest countries, have perceived FATCA as an opportunity to boost AEOI at EU and international levels by extending the scope of reporting both geographically and in terms of products. They decided to help the US implement FATCA by developing a legal framework through Inter-Governmental Agreements (IGAs), allegedly aimed at reducing FFIs' costs, but actually meant to address some legal obstacles. The FATCA IGA Model 1 is based on a non-contractual approach which provides for indirect reporting, i.e. partner jurisdictions' FFIs have to report certain financial account information to their local tax authorities rather than to the IRS, while the U.S. and the Partner Country have to exchange information about each other's taxpayers. The FATCA IGA Model 2 has been developed by Switzerland and Japan. Unlike Model 1, Model 2 provides for direct reporting to IRS on an aggregated basis, with possible request for information. The FATCA Regulations[43] only apply when the FFI is established in a non-partner jurisdiction.

OECD Common Reporting Standard (CRS)

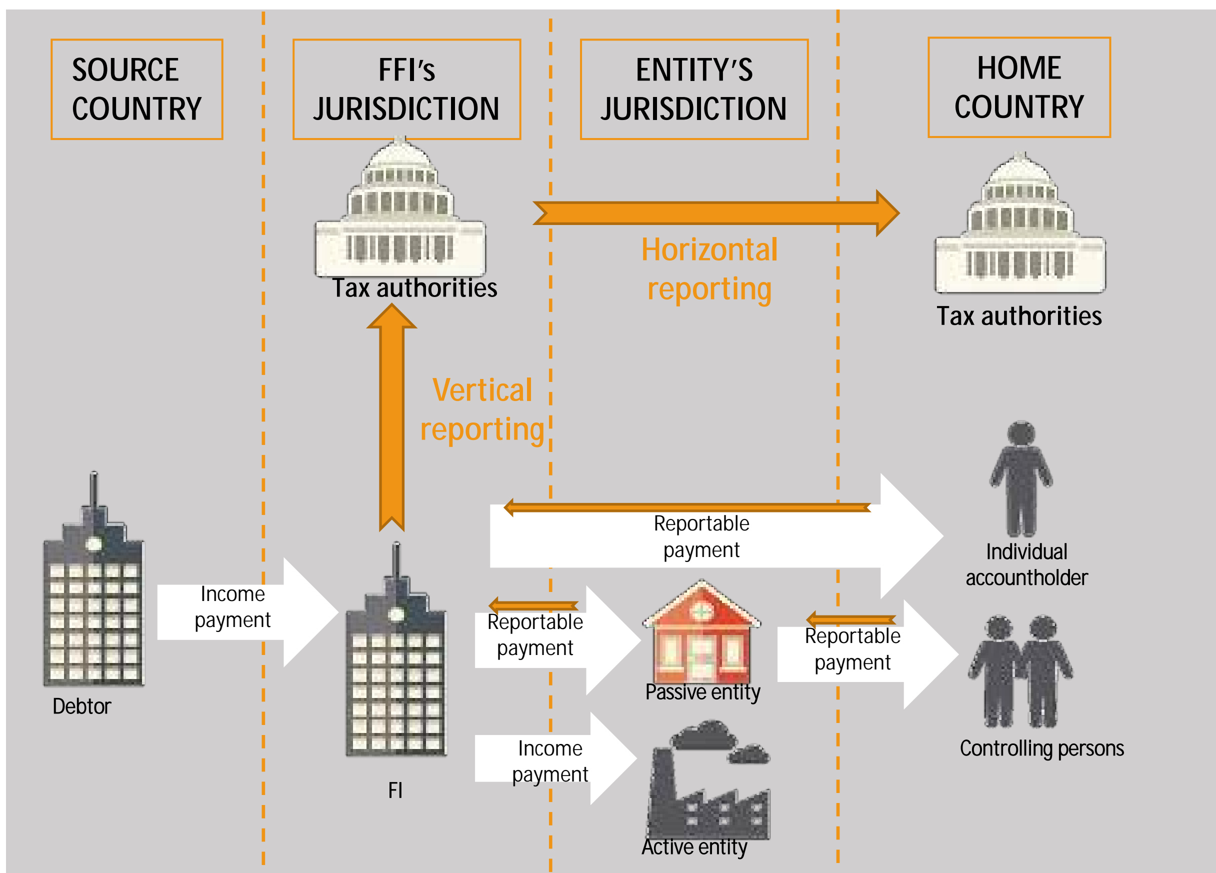
In September 2014, the OECD, which had focused on AEOI since 2011, presented the G20 Finance Ministers with a package for a global approach to AEOI using FATCA IGA Model 1 as a benchmark. It was endorsed by the G20 in Brisbane in November 2014. This package encompasses a conceptual framework, the Common Reporting Standard (CRS), detailed CRS commentaries, a schema for reporting (technical interface) and a model bilateral/multilateral agreement (Competent Authority Agreement - CAA) to be used as a legal framework by partner jurisdictions.

The CRS provides for indirect reporting of information combining a vertical reporting by FIs to their local tax authorities and horizontal reporting between tax authorities of the FI's host country and the tax authorities of the country of residence of the clients.

[42] A NFFE is defined as a foreign entity that is not an FFI. Excepted NFFEs, which are exempt from withholding, include: active NFFEs (engaged in an active non-financial business), listed companies, government entities, international organisations and central banks. A NFFE is US-owned if there is a direct or indirect participation < 10% if located in a non-partner country and < 25% if located in a partner country.

[43] Regulations issued on 17 January 2013 by the US Treasury. ; Temporary Coordinated Regulations of 6 March 2014.

FIG. 7: Reporting mechanisms under the Common Reporting Standard



The scope of the CRS is very broad in terms of reporting FIs, reportable account holders and reportable information.

Reporting FIs, i.e. legal entities that are directly responsible for fulfilling the reporting obligations, include banks, custodians and other financial institutions including certain brokers, certain collective investment vehicles and certain insurance companies.

Reportable accounts are accounts held by individual clients whose tax residence is in another participating jurisdiction. They also include accounts of legal entities, regardless of their legal form (including trusts and foundations), that are not classified as FIs and are therefore designated as non-financial entities (NFEs). FIs have to identify individual clients (and their residence) and certain "reportable" entities (both passive and active) and to look-through some passive entities (not engaged in a non-financial business) in order to identify individuals who exercise a controlling influence on these passive entities.

The reportable information includes personal data (name, address, tax residence and TIN) and financial information (account balance, all investment income including sales proceeds).

To determine which accounts are affected by the reporting obligation, the OECD standard provides for extensive documentation and due diligence obligations for FIs. The affected FIs have to identify direct and indirect account holders in their client base, i.e. to distinguish between individual accounts and entity accounts, and to distinguish between pre-existing accounts and new accounts by reference

to the start date of the CRS implementation. FIs also have to identify the residence of individual account holders. Overall, if the tax domicile of a client cannot be determined on the basis of the available information, a self-declaration must be obtained from the client and this self-certificate has then to pass a, “reasonableness test.” After the CRS comes into effect, FIs will have to apply the new accounts due diligence procedures, i.e. clients will always be requested to provide such a self-declaration to confirm the tax domicile when new client relationships are opened.

The pre-existing individual accounts due diligence procedures can be summarised as follows:

- There is no de minimis threshold for individual accounts;
- Lower Value Accounts (< 1 million $): permanent residence address test based on documentary evidence (so-called, “B1 procedure”) or electronic indicia search (“B2 procedure”) unless there is a self-certificate;
- Higher Value Accounts (> 1 million $): enhanced due diligence procedures (manual paper record indicia search and actual knowledge test by the relationship manager) unless there is a self-certificate.

According to the new individual accounts due diligence procedures, self-certification is always required, together with a reasonableness test, and there is no de minimis threshold.

The pre-existing entity accounts due diligence procedures provide for the following rules:

- Optional de minimis threshold according to which there is no review for accounts below 250 000 $;
- Entities which are reportable persons are identified based on available information, (i.e. according anti-money laundering (AML) procedures / Know-Your-Customer rules - KYC) and on self-certification in certain cases;
- Passive NFEs and controlling persons are identified based on available information under KYC rules if it is a Lower Value Account (< 1 million $) and through self-certification if it is a Higher Value Account (> 1 million $) unless publicly available information indicates that the entity is an active NFE or an FI.

According to the new entity accounts due diligence procedures, the same assessments are required as for pre-existing accounts, but there is no minimal threshold and self-certification is always required to identify reportable persons.

Early adopters and EU Member States' Implementation Calendar

At the 7th meeting of the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes in Berlin on 28-29 October 2014, a group of 51 jurisdictions collectively known as the Early Adopters Group, and including most EU Member States, signed a multilateral competent authority agreement on implementation of the automatic exchange of information standard. In a joint statement published ahead of this meeting, they committed themselves to early adoption of the new standard and provided specific timelines for implementation coinciding with the FATCA implementation calendar + 18 months, i.e.:

- 1 January 2016: Cut-off date to distinguish pre-existing accounts from new accounts;
- 31 December 2016: The due diligence procedures for identifying high-value pre-existing individual accounts shall be completed;
- 31 December 2017: The due diligence for low-value pre-existing individual accounts and for entity accounts shall be completed;
- by the end of September 2017: first exchange of information between tax authorities in relation to new accounts and pre-existing individual high value accounts;
- by the end of September 2017 [or September 2018 depending on when financial institutions identify accounts as reportable accounts]: first exchange of information between tax authorities about pre-existing individual low value accounts and entity accounts.

The Review Directive on Administrative Cooperation (DAC2) adopted by ECOFIN on 9 December 2014 will be used to implement the CRS in the EU for intra-community payments. The directive provides an implementation calendar aligned with the calendar of the CRS early adopters.

Implementation challenges with CRS and DAC2

Urgent need for consistent implementing guidelines

The implementation of the CRS and DAC2 will be a difficult task for both FIs and tax administrations. FIs need to know the details of clear guidance before starting to adapt and develop their systems in order to comply with the due diligence and reporting requirements. In many cases no detailed budgeting process to secure the funds to implement the CRS can be approved internally or finalised until there is a final legal framework and obligation to implement under local law in each country concerned. FATCA has demonstrated that FIs face an uphill struggle to implement complex regulatory programmes in a short timeframe.

The report released 13 March 2015 by the Commission's Expert Group on Automatic Exchange of Financial Account Information points out that some governments seem to believe that they do not need to issue any further guidance (beyond the CRS commentary which has been developed by the OECD) or amend domestic legislation. However, each jurisdiction must issue detailed guidance in order to clarify procedures and what data FIs need to capture, provide definitions (the in-scope entities) and indicate their choice on a number of options. In order to level the playing field, Member States should adopt common guidance following the same and consistent format so as to ease compliance by FIs operating in multiple Member States. Member States should commit themselves to apply the 'DAC2 standard' for the purposes of exchanges of information with non-EU Countries. Without this, FIs would end up applying different standards and due diligence processes depending on the country of residence of the beneficiary.

Definitional issues

It is essential for consistency between all participating countries to confirm that the OECD commentary to the CRS also applies to DAC2 and to highlight any divergences, if any, as divergent interpretations of any definitions from one Member State to another could potentially lead to important distortions within the internal market.

A clear and unequivocal interpretation of the concepts of financial account and investment entity is instrumental for the purpose of the implementation of the CRS. The issue is of particular relevance for private investment companies and trusts, which, depending on the prevailing interpretation, would qualify either as investment entity, in which case applicable reporting requirements would directly vest to these entities[44], or as Passive NFE, in which case the relevant equity/debt holders of any such entity would be reported by the upstream FI that maintains a financial account for the entity, in most, if not all, cases, a bank (see Fig. 7).

Lists of excluded accounts and non-reporting financial institutions

Both the CRS and DCA2 enable jurisdictions to draw lists of excluded accounts and non-reporting FIs. It is crucial that the list established for purposes of DAC2 can also be applied for the purpose of the CRS on a global basis, otherwise FIs would be obliged to apply two sets of excluded accounts and entities, one under the DAC, and one under the CRS as applied vis-à-vis non-EU jurisdictions. Member States have a deadline of 31 July 2015 by which they should provide the list of non-reporting financial institutions and excluded accounts to the Commission.

Guidance on due diligence

The due diligence procedures for pre-existing accounts are designed to create operational efficiencies for participating jurisdictions' FI's, but require adjustment in order for such an efficiency to be realised. For example, collection of the TIN, date and place of birth means FI's need to contact pre-existing individual customers in any event. This requirement is extremely burdensome and should be simplified.

[44] Unless appropriate delegation or sponsoring provisions are made available.

In relation to investment entities that are not located in a participating jurisdiction, FIs must treat them as passive NFEs and therefore need to identify their controlling persons. Since existing Anti-Money Laundering rules in a number of EU Member States do not require any additional due diligence to identify the controlling persons or senior managing official notably of regulated funds and the chain of ownership, it will be difficult, if not impossible, to obtain self-certifications from the underlying investors in such funds.

The CRS envisages the use of self-certifications. Where this data is not electronically collected there is a current market issue in that many paper forms have been developed causing confusion in the market place for both FIs and customers. In order to have a consistent approach and allow effective and efficient processes a possible approach may consist in the development of potential self-certification best practices, which could be published in Member States' guidance.

Additional Member State guidance is needed in the area of the reasonableness test, as it may raise significant legal and operational uncertainty. In particular, it should be clarified that only the core data fields of the self-certification form should be submitted to the reasonableness test.

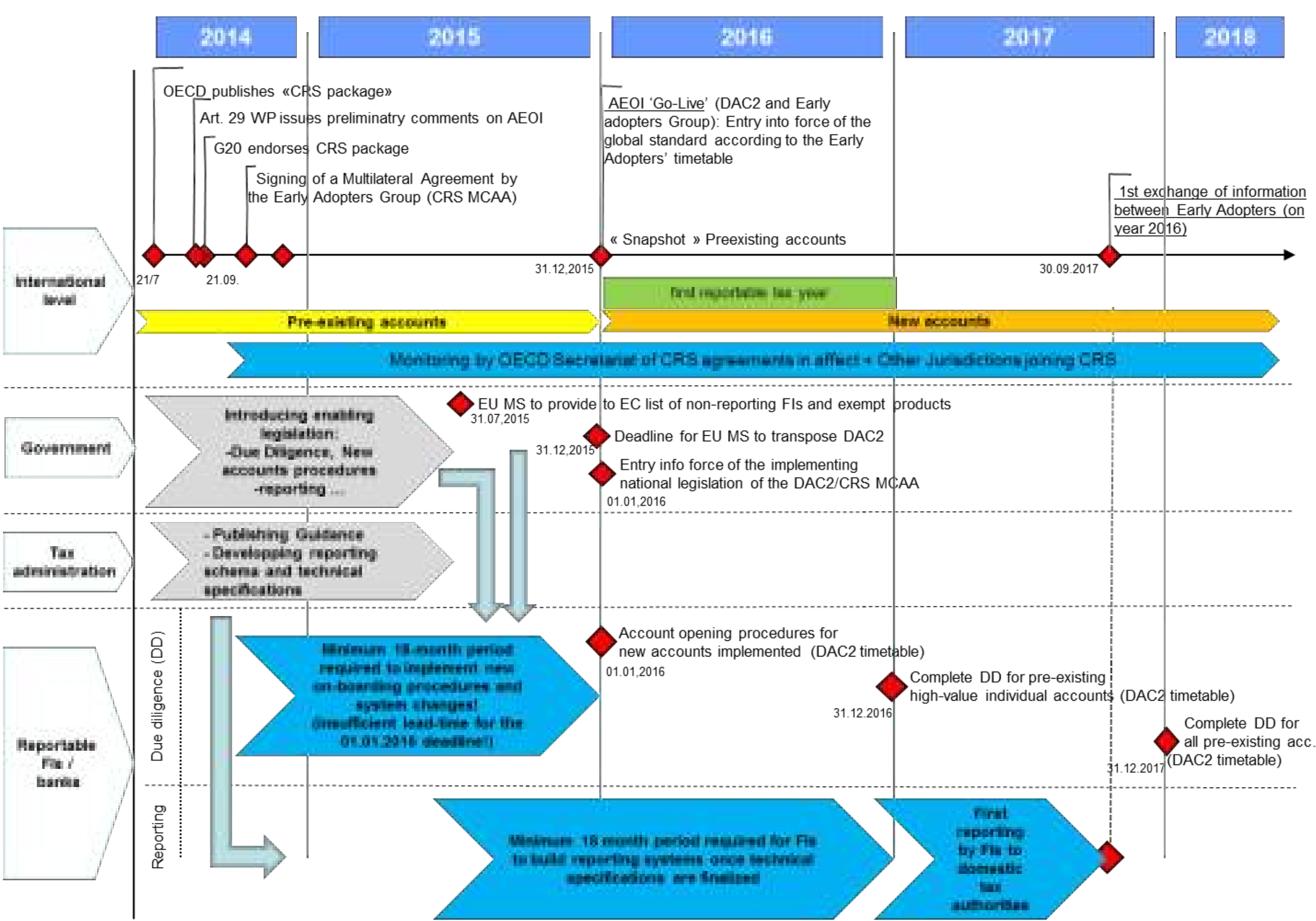
Time lines

DAC2 provides that a Member State will be in compliance with the directive to the extent that it has enacted implementing legislation by 31 December 2015, and this for a date of entry into force of 1 January 2016. In addition, it is imperative that comprehensive guidance be published by domestic authorities in early 2015. At the same time, FIs will need to receive detailed technical specifications for reporting formats and communications channels.

Generally, FIs require a lead-time of at least 18 months in advance of the effective date, starting from the time the final guidance has been released. In respect of the entry into force of the DAC2 provisions in Member States that 18-month deadline has already passed.

Past experience with FATCA suggests that there is a real risk that many Member States will go right to the wire with the release of such implementing legislation. The implementation calendar currently envisaged means that DAC2 will have to be implemented in a much shorter timeframe than as the case for FATCA. There are fundamental differences between DAC2 and FATCA, with the result that large FIs have substantial IT projects to plan, budget for, build/source and roll out – all of this in a very short space of time.

FIG. 8: Implementation calendar of DAC2



Phased approach

Serious consideration should therefore be given to a phased approach to implementation. Reporting could be pushed back by one year, with the first reporting to be made in 2018 and to include data in respect of both 2016 and 2017.

Soft landing

Additionally, it should be noted that FIs are likely to have tactical solutions when implementing the CRS/DAC2, due to the lack of time available between the issuance of requirements, implementing legislation, local country guidance and the commencement date. It will take two-to-three years for FIs to fully address these system issues. Therefore, there should be a 'soft landing' period of two years for FIs located in the EU or early adopter locations, during which tax administrations and FIs would engage in dialogue and mutually seek to reach a fully operational system.

Wider approach

As from the start of the global AEOI initiative, the European Banking Federation has called for a holistic (or big bang) approach, i.e. the adoption and implementation of the CRS at the time by all interested jurisdictions. Because some jurisdictions have decided to be early adopters, while others have opted for a second wave adoption and others will step into the process only at a later stage, FIs are facing a fragmented approach.

The principles of data reduction and data economy which are enshrined in some jurisdictions' data protection law, may prevent FIs from collecting and storing Tax Identification Numbers (TINs), tax residency information and self-certifications when clients are resident in a non-participating or an initialled jurisdiction or when the relevant legal instruments are not yet in effect. As a consequence, FIs may not be able to search the whole customer base in one step and may have to reiterate this exercise each time a jurisdiction effectively becomes a participating one. The implementation burden and costs to FIs will be exponentially increased if FIs cannot collect, document and report all tax residences and controlling persons information from day one of the regime, and are forced to repeatedly re-examine all accounts for new jurisdictions joining the regime. Therefore domestic laws must be amended to ensure that clients should only need to be contacted once to collect all tax information and consequently FIs must be able to retain that information until required for reporting.

Clear guidance is required on how FIs resident in the early adopter jurisdictions should treat entities (particularly deemed-passive NFEs) that are resident in second wave adopter jurisdictions. A single definition for pre-existing and new accounts (independent of whether the jurisdiction is an early adopter or not) would give welcome certainty, meaning that early adopter country FIs would need to carry out only a single due diligence wave covering all pre-existing accounts.

Concluding remarks

Need for tax relief at source

The period within which withholding tax refunds can be claimed varies among Member States, and may even vary within the same Member State depending on the treaty under which the refund is claimed. Similarly, the time to obtain a refund of withholding tax may vary from a few weeks in some Member States (e.g. the Netherlands) to many years in other Member States (e.g. Italy).

The process for claiming withholding tax relief has deteriorated over time in many countries, resulting in increased costs and protracted delays for cross-border portfolio investors. The types of burdensome procedures increasingly faced by investors include:

- extensive, non-standardised documentation requirements, often for each income payment;
- the need to hire local counsel to pursue relief procedures;
- requirements for residence country tax administrations to provide certificates tailored to requirements of the source country;
- unclear or unreasonably complicated requirements for withholding tax relief on payments to Collective Investment Vehicles (CIVs), contrary to the OECD's recommendations; and
- lack of an effective refund procedure.

The complexity and cost of obtaining the tax relief to which an investor is legally entitled often lead investors to forego the relief and full withholding at the maximum tax rate is then the outcome. Even though the financial intermediary has access to accurate customer information and is subject to high compliance regulation standards, obtaining tax relief to which its customers are entitled is often not practicable. This undermines the objectives of treaties that aim to reduce disincentives to cross-border investment.

Governments should take steps to implement a standardised and harmonised system for tax relief at source and simplified tax refund procedures simultaneously with the CRS. The most advanced work in this area has been the development by the OECD Member State governments of the TRACE Implementation Package (TRACE IP) of which certain features, such as the ability for financial institutions to voluntarily participate in the relief system, should be retained.

Fundamental concerns about Automatic Exchange of Information

Banking activities consist of transforming financial risks and of providing intermediation services and payment facilities. In this respect, banks carry out their essential functions with the aim of serving their clients, building commercial relationships based on trust and confidentiality and pursuing the objective of making profits out of these core business activities. At the same time, they are requested by tax authorities to play a role as tax intermediaries, which mainly consists of systematically disclosing investors' information. The tension between these different tasks has been further exacerbated by the financial and economic crisis and an increasing desire of governments to combat tax fraud.

All stakeholders, including in the banking sector, understand the need to fight against tax evasion. However, there is no compensation fee for these tax compliance activities, which require banks to make huge investments and incur substantial running costs. In addition, banks are held liable for errors which may happen in the compliance process and they may be penalised in case of non-compliance. In the absence of a level playing field for compliance requirements, European banks may be put at a disadvantage compared to offshore banks with which they are competing. Excessive tax compliance requirements might undermine the profitability of the European banking sector and hence have unintended consequences on growth and employment. Tax compliance requirements should never exceed what is economically sustainable.

The geography of Europe is such that one may live in France, work in Luxembourg and have another property in Germany, possibly resulting in more than one tax residence. Having accounts

in each of those places does not necessarily constitute evidence of tax evasion, but it could simply be for convenience. There are hundreds of millions of accounts within Europe. Early estimates suggest at least 10% of these will have a cross-border link. This means that in the CRS/DAC2 framework data on tens of millions of accounts will be shared between tax authorities and will need to be examined or analysed by tax authorities, albeit the vast majority of account holders will not be using these to facilitate any form of tax evasion. It is questionable whether CRS and DAC2 are an adequate and proportionate solution.

The question of the proportionality of reporting requirements is also relevant in respect of the clients' rights to privacy and data protection, which are fundamental rights under EU law[45]. It is crucial to ensure that DAC2 is fully compatible with these fundamental rights and does not bear the risk of being challenged before the Court of Justice of the European Union. Particular attention should be paid to the proportionality of data processing and retention, controllership and security measures, and onward transfer-related issues. Prior to the implementation of DAC2, governments should carefully consider the statement made by the Article 29 Working Party on 4 February 2015.

On a more political aspect, certain non-EU countries may not have appropriate data protection rules and confidentiality arrangements in place. For political reasons, the transfer of account holders' data to such countries may be a sensitive issue. DAC2 does not provide any effective mechanisms to assess whether a third country's legal framework provides an appropriate protection of the data transferred under AEOI. Member States should adopt a common approach to develop objective criteria for such assessment.

[45] Charter of fundamental rights of the European Union, European Convention on Human Rights, Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data 108/1981, Article 16(1) of the Treaty on the Functioning of the European Union, Data Protection Directive 95/46/EC.

APPENDIX: TABLE OF ACRONYMS

AEFI Group:	Commission's Expert Group on Automatic Exchange of Financial Account Information for Direct Taxation Purposes
AEOI:	Automatic Exchange of Information
BIAC:	Business and Industry Advisory Committee
CCA:	Competent Authority Agreement
CIV:	Collective Investment Vehicle
CJEU:	Court of Justice of the European Union
CRS:	Common Reporting Standard
DAC:	Directive on Administrative Cooperation
DAC2:	Directive on Administrative Cooperation – 2nd Revision
MS:	Member States
EBF:	European Banking Federation
EU:	European Union
EUSD:	EU Directive on the Taxation of Savings
FATCA:	Foreign Account Tax Compliance Act
FFI:	Foreign Financial Institution
FI:	Financial Institution
IBFed:	International Banking Federation
IGA:	Intergovernmental Agreement
IRS:	Internal Revenue Service
MCCA:	Multilateral Competent Authority Agreement
NFFE:	Non-Financial Foreign Entity
NFE:	Non-Financial Entity
OECD:	Organisation for Economic Cooperation and Development
PFFI:	Participating Foreign Financial Institution
PJFI:	Participating Jurisdiction's Financial Institution
PEP:	Politically Exposed Person
QCCI:	Qualified Credit Card Issuer
QI:	Qualified Intermediary
QIA:	Qualified Intermediary Agreement
TIN:	Tax Identification Number
TRACE (IP):	Treaty Relief and Compliance Enhancement (Implementation Package)
XML:	eXtensible Markup Language

Measures against harmful tax competition in Turkey

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Introduction[46]

International tax competition has significantly increased since the 1980s as a result of liberalised financial and fiscal policies, whilst at the same time, sovereign nations faced budgetary deficit problems and public finance related considerations. This paper aims to analyse measures that have been taken against harmful tax competition in Turkey. As part of these measures, a new Corporate Income Tax Law (CITL) was introduced in 1996. One of its aims is to combat harmful tax competition, and, therefore, it covered defensive measures such as controlled foreign company (CFC) and transfer pricing practices, which are intended to prevent companies from leaving their foreign subsidiaries' income abroad.

Recently, the issue of international tax competition has risen to the fore in fiscal and political policy debates. International flows of capital and goods and services around the world over the past decades have produced significant challenges for developed and developing countries. Using the facilities of some countries commonly referred to as tax havens, individuals hide their assets and businesses reduce their profits from being taxed where they reside and from where they avail of public services. It is often argued that tax havens, as with other examples of tax competition, erode the tax base of high-tax countries by providing avoidance opportunities to taxpayers. This leads governments to take action against harmful tax competition. Governments may respond to international tax competition that is considered harmful in one of two ways - by taking measures unilaterally as a single country or they can take part in international cooperation.

Governments can defend their sovereign fiscal rights behind their national frontiers by making legislation and taking necessary precautions. However, the legislative armoury of a single country to counteract harmful tax competition is insufficient to fully address the problem. Therefore, the second route is cooperation with other governments that are facing the same tax evasion problems, which includes sharing information across borders.

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International tax competition

International tax competition has led countries to implement tax reforms within their national borders that have both broadened the tax base and lowered tax rates. Increased international mobility has increased tax competition and put downward pressure on tax rates[47]. Many OECD countries have lowered both their personal and corporate income tax rates during the last decades. For instance statutory corporate income tax rates have fallen globally from average of 50 per cent in the mid-1970's to 30 per cent in 2000's. On the other hand, tax rate reductions are compensated for by additional tax base broadening measures. One way of broadening the tax base is to limit provisions in the tax code used by tax authorities to encourage certain activities or that support taxpayers in special circumstances. It is often argued that special tax reliefs are introduced in response to tax competition[48]. However, broadening the tax base and lowering tax rates are central to the debate on tax equity and fairness. Moreover, many governments, in order to combat tax havens, have introduced new regulations such as controlled foreign corporation (CFC) or redefined their transfer pricing legislations.

The second option is cooperation with other governments that are facing same problems. In this context, as stated in the Economic Communiqué of G7 Lyon Summit, the OECD established an international framework to counter the spread of harmful tax competition and published its report, *Harmful Tax Competition: An Emerging Global Issue* in 1998. Following the publication of this report, the OECD has focused on two issues: tax havens and preferential regimes in member countries. The OECD has forced tax havens to cooperate and member countries to curtail preferential regimes. In 2000, OECD listed 35 jurisdictions found to meet the tax haven criteria[49]. The 1998 Report suggested that defensive measures would be more effective if applied by a wide number of countries. Some of the measures were for countries that do not have CFC or equivalent rules in place - to consider adopting such rules or to impose withholding taxes on certain payments to residents of uncooperative tax havens. The OECD work continues today as the Global Forum on Transparency and Exchange of Information for Tax Purposes.

For the same reason, the European Council agreed on 1 December 1997 to a package of measures to tackle harmful tax competition in order to help reduce distortions in the Single Market, to prevent excessive losses of tax revenue and to develop tax structures. The package included a Code of Conduct on business taxation, taxation of savings income and the issue of withholding taxes on cross-border interest, royalty payments between companies and, also, a commitment to roll back existing preferential regimes and refrain from introducing any such measures in the future. The code is not a legally binding instrument but it clearly does have political force[50].

Tax competition and Turkey

As a result of the liberalisation policies of the 1980s, Turkey faced several effects of international tax competition. As a member of OECD, Turkey participated in OECD *Harmful Tax Forum* work and committed to eliminate any

[47] OECD (2006), Fundamental Reform of Personal Income Tax, Tax Policy Studies No.13, Paris, p.8.
[48] OECD (2010), Choosing a Broad Base- Low Rate Approach to Taxation, Tax Policy Studies No.19, Paris, p.106.

[49] See, OECD (2000), Towards Global Tax Co-Operation: Progress in Identifying and Eliminating Harmful Tax Practices, Paris.

[50] EU, http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/[July 7,2014]

preferential tax regimes found to be harmful. In this scope, following an analysis of the Istanbul Offshore Banking Regime (IOBR) and the Turkish Free Zones (TFZ), the IOBR was abolished and the TFZ was found not to be harmful[51]. Additionally, Turkey had to take counter-measures to tackle harmful tax competition in order to deal with loss of revenue. Consequently, Turkey reduced personal and corporate income tax rates, broadened the tax base, introduced a new Corporate Income Tax Law in 2006 (which covered measures such as controlled foreign companies and transfer pricing practices), extended the scope of exchange of information in tax treaties and reformed the tax administration.

Within this framework, the measures against harmful tax competition that have been taken in Turkey are detailed below:

Reducing tax rates and broadening the tax base

In Turkey, personal income and corporate tax rates are declining and the tax bases are being widened by eliminating deductions and exemptions. For instance, the corporate tax rate was reduced from 30%-to-20% in 2006. For individual tax payers, the highest income tax rate was reduced from 45%-to-35%.

Controlled foreign company (CFC) regulations

The OECD has supported implementation of control foreign company (CFC) regimes as a way of countering the routing of profits to tax havens or low-tax jurisdictions. In an environment of ever increasing international tax competition, Article 7 of CITL introduced CFC provisions into the Turkish tax system on 1 January 2006. According to this Article, the income derived from a foreign subsidiary by a taxpayer – whether distributed or not - is subject to taxation in Turkey if individuals and corporations directly or indirectly, separately or together, hold 50% of the foreign subsidiary's capital, share of profit or voting power and when the conditions below occur concurrently:

a) 25% of the subsidiary's gross income consists of *passive incomes*, such as interest income, dividend income, license fees and security income, that are not sourced from commercial, agricultural or self-employment activities that require capital, organisation and employment;

b) the foreign subsidiary has a tax burden with similar characteristics to income and corporate income tax that is lower than 10% of the commercial balance sheet profit;

c) the foreign subsidiary's annual gross income exceeds TRY 100,000 or a foreign currency equivalent of this amount.

The tax burden of the subsidiary should be at least 15% of the income earned in the country of operation. Control of the subsidiary is based on the highest percentage owned in any date within the related accounting period. If the relevant conditions are met, the profit of a foreign subsidiary is included in the controlling party's corporate income tax base beginning from the accounting period that contains the closure month of the foreign subsidiary's accounting period, prorated according to its control proportion. If the income taxed in Turkey is later redistributed by the foreign subsidiary, the untaxed part of the profit is subject to corporate income tax. From 2007, individual taxpayers' incomes from CFC's are included under Personal Income Tax law.

[51] OECD (2006) , OECD' Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries.

Transfer pricing

As a part of the effort to combat harmful tax practices, transfer pricing rules were first introduced by Article 13 of CITL on 1 January 2007.The regulation is mainly based on the OECD's work on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. According to this article, corporations shall be deemed to have "profits distributed in a disguised manner" through transfer pricing, if they are engaged in buying goods and services from persons or entities that are not priced in accordance with the arm's length principle. In such cases, profits distributed in a disguised manner shall not be allowed as an expense in the calculation of corporate earnings for tax purposes.

The arm's length principle is defined as using the price or value that would apply if the parties involved were independent from each other, and not in the position of related parties. The methods for the determination of arm's length transfer prices are: the *comparable uncontrolled price method*, the *cost plus method* and the *resale price method*. If the aforementioned methods cannot be used by the company for certain situations, the taxpayer will be free to adopt other methods. According to the General Communiqué No. 1, the other methods are defined as the following: the *profit split method* and the *transactional net margin method*. It's also possible for companies to have unilateral, bilateral or, multilateral advance price agreements with Ministry of Finance.

Thin capitalisation rule

To counteract negative consequences of debt finance tax collection, many countries have instituted thin capitalisation rules that restrict the deductibility of interest above a certain debt level[52]. In Turkey, the thin capitalisation rules were revised as part of CITL in 2006.

When the ratio of borrowings from shareholders (or related parties to the shareholders) exceeds three times the shareholder's equity of the borrower company, the amount in excess of this limit shall be deemed as thin capitalisation in the related accounting related period. Except for loans received from credit institutions that provide loans only to related companies, i.e. that have no external customers, half of the loans received from related banks and similar institutions are taken into account during thin capitalisation calculations. The scope of the term "related parties" consists of shareholders and persons related to shareholders that own 10% or more of the shares, voting rights or right to receive dividends of the company. Except for the foreign exchange differences, interest paid over an excess debt/equity ratio is considered as distributed dividends and will be subject to 15% dividend withholding tax.

Following the introduction of these regulations, and as part of reform of tax administration a new thin capitalisation, transfer pricing and cross-border transactions division was set up at the Tax Audit Board of the Ministry of Finance in 2011.

[52] Blouin J., Huizinga H., Laeven L& Nicodème G (2014). **Thin Capitalization Rules and Multinational Firm Capital Structure**, IMF Working Paper WP/14/12 p.3

Withholding tax on payments related to residents of tax havens

In order to secure collection, certain taxes are levied at the point of disbursement. In many tax systems, those disbursements subject to withholding tax include, for resident individuals, income tax on salaries of employees, lease payments to individual landlords, independent professional service fee payments and for non-residents, royalty, license and service fee payments,.

As mentioned earlier, one of defensive measures suggested by the OECD against the tax havens is to impose withholding taxes on certain payments to residents of uncooperative tax havens. According to Article 30/6 of CITL, payments made to corporations (including branches of resident corporations) that are established in or operational in countries that are regarded as undermining fair tax competition (due to their tax rates and other practices), will be subject to withholding tax at the rate of 30% in Turkey, irrespective of whether the payments in question have been subject to tax or not or whether the corporation receiving the payment is a taxpayer or not. The Council of Ministers is authorised to determine the withholding tax rate for payments of goods and participation stock purchased at fair market value, for leasing payments for sea and air transportation vehicles and payments that are mandatory to complete work.

However, a list of countries whose residents will be affected by this provision has yet to be published.

Exchange of information

One of the main recent concerns of the OECD Harmful Tax Project is the exchange of information between tax administrations. Article 26 of the OECD Model Tax Convention provides a basis for information exchange. Also, the Tax Information Exchange Agreement (TIEA), introduced by OECD in 2002, is a bilateral agreement to be negotiated and signed between two countries to establish an official system for the exchange of information relating to taxes. This internationally agreed tax standard allows an exchange of information, on request, of all tax matters required for the administration and enforcement of domestic tax law, without regard to a domestic tax interest requirement or banking secrecy for tax purposes. So far, Turkey has signed 80 double tax agreements in accordance with Article 26 of the OECD model convention. In addition, Turkey has signed TIEA with Jersey and Bermuda, which came into force in 2013.

Evaluation

This work centres on measures against harmful tax competition in Turkey. The argument about whether or not tax competition is harmful is beyond the scope of this study. Governments take measures against tax havens in two ways - they introduce domestic tax regulations within their borders and/or they cooperate with other countries that are also threatened by harmful tax competition. Turkey, as a member, participated in OECD *Harmful Tax Forum* work and abolished the Istanbul Offshore Banking Regime. In the domestic law context, the government in Turkey has reduced personal and corporate income tax rates, broadened the tax base by eliminating exemptions and exclusions, and introduced a new Corporate Income Tax Law in 2006. This introduced measures such as CFC and transfer pricing provisions, extended the scope of exchange of information agreements and double taxation treaties and reformed the administration of tax.

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EU, http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/[July 7,2014]

Belgium's response to aggressive tax planning: state of play

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Introduction[53]

"*I can hang a notice on my door saying that I intend to escape Belgian law and that it is for that reason and that reason only that I am going to set up a company abroad under foreign law. And no one can legally prevent me from doing so...*" wrote Professor of Tax Law Raymond Vander Elst some years ago[54].

In a country like Belgium, where the tax burden is on the higher side of the scale, the inclination to evade tax becomes all the greater. This can manifest itself in various ways. Firstly, taxpayers can decide to cease an activity for which a large portion of the proceeds is known to go to the taxman. Others will choose to take the proceeds but, deliberately violating tax law, won't bother to declare them and cheerfully resort to tax fraud. Another possibility is to avoid the application of the tax legislation by ensuring that the income received is not subject to Belgian tax. In that case, we are talking about tax evasion. And finally, a taxpayer can decide to set up a company in a country where the tax rate is similar to the Belgian one in principle but where certain forms of income enjoy more favourable treatment.

The object of our contribution is to answer the following questions: faced with a variety of ways and means to evade tax, with the complexity of international fiscal engineering mechanisms designed to evade tax and with the fertile imagination of distinguished tax consultants, what instruments does the Belgian tax administration have at its disposal to challenge the legality of certain transactions performed via the incorporation of a company abroad or to thwart certain profit transfers to that foreign company? Are these instruments used enough and are they actually effective? What critical eye

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[54] Vander Elst R.,"La fraude à la loi en droit international privé (Fraud in Private International Law)", in Mélanges Baugniet, p 799. As the author states, one of the most traditional ways to evade tax, for a Belgian taxpayer, is to resort to companies in tax havens that do not impose any corporation tax or a corporation tax that is laughable.

can we cast on the manner in which the Belgian taxman deals with aggressive tax planning? Following an exposé of the existing anti-abuse rules, we will look at the effectiveness of these measures and at their scope.

An impressive legal arsenal

Out of a legitimate desire to plug all the gaps some taxpayers were all too keen to sneak through, the Belgian legislator has, year after year, come up with various new anti-abuse provisions, be it general or specific ones.

The general anti-abuse measure and simulation

Under Belgian tax law, case law of the Court of Cassation upholds the principle of freedom to choose the path of least taxation. [55]

This freedom to choose presupposes, however, that there is no simulation, a fundamental principle of Belgian tax law. Simulation is a misrepresentation of the truth. If the administration (notably by way of presumption) can establish the fictitious or simulated nature of any transactions it comes across, the transactions in question lose all probative effect. This misrepresentation of the truth ensues from a situation that precedes the tax return. The taxpayer 'paves the way' with fiscal errors, intellectual errors, etc. There are no shortages of examples: falsification of inventories, of the annual accounts, backdated documents (such as invoices, payslips), misrepresentation of the truth in agreements the taxpayer concluded. Simulation comes in many forms.

[55] In a famous judgment (Cass. [Court of Cassation] 16 June 1961, Pas.1962, I, 1082) The Court of Cassation ruled that "*There is no question of unlawful simulation vis-à-vis the taxman or of tax fraud if the taxpayer, for the purpose of benefitting from a more beneficial tax treatment, making use of his right to freely conclude contracts, conducts transactions for which he accepts all the consequences, even if they are not the most regular*".

For a few years now, the tax administration can also invoke tax abuse in respect of certain tax transactions (article 344§1 of the 1992 Income Tax Code, hereinafter: ITC). Tax abuse comprises an objective and a subjective element. The objective element implies that the taxpayer opts for a legal transaction or a series of legal transactions that allow him to arrive at a situation that contravenes the objectives of a provision of the ITC or its implementing decrees. The subjective element implies that the taxpayer opts for this legal transaction or for this series of legal transactions with the essential objective of obtaining a tax benefit. The administration only has to prove the objective element. When it comes to the subjective element however, it is up to the taxpayer to demonstrate that it does not exist by proving that his choice of legal transaction or series of legal transactions is justified for reasons other than trying to avoid income tax.

In matters of corporation tax, however, transactions that might once have been deemed to come within the scope of choosing the path of least taxation will henceforth get the taxman's full attention as he now has a legal instrument to counter (or at least to try to counter) certain well-known transactions: breaking-up of ownership, the use of management companies, intercompany transfers, the leasing of property followed by sub-leasing, the creation of financial vehicle corporations (which the taxman qualifies as artificial arrangements if their legal and economic reality is not demonstrated), the liquidation of one company followed by the incorporation of a new company with an identical corporate objective, the abuse of the favourable tax regime governing copyright, the inappropriate use of risk capital deductions (notional interests), leasing of clientele or goodwill, etc.

These are only some of the transactions the taxman may examine in light of the anti-tax

fraud provision but, in our opinion, with limited chances of success.

The administration may find that exposing tax fraud is easier said than done.

Let's take one-man companies for instance: is it abusive to set up a one-man company to avoid being liable for Belgian personal income tax and to a priori avail oneself of the more favourable Belgian corporation tax? In reality, the mere fact of creating a management company brings the taxpayer legally within the scope of the provisions of the ITC that fix the corporation tax rates and tax bases. As a result, by opting for corporation tax rates, the management company is only complying with the objective of the Belgian legislator, who is happy to grant companies a different tax rate than the one he applies to natural persons. Furthermore, it will be far from easy for any tax inspector to resort to this provision when genuine economic, family or financial reasons justify the creation of a company and this, in spite of the tax benefits that come with it.

Numerous specific anti-abuse measures

Over the decades, the Belgian legislator also worked out a set of rules to combat tax avoidance in well-specified cases. Among these numerous provisions, which this article is unable to examine in their entirety, we will first look at substantive article 26 of the ITC, which allows the tax administration to add, "*abnormal or gratuitous advantages*," to the taxable profits, whether they have been granted to interdependent companies or to third parties. Benefits like these can come in the form of expenses or ensue from a lack or shortage of income. This provision therefore constitutes a fundamental exception to the principle that only profits are taxable.

The Law of 21 June 2004 (MB [Belgian Official Gazette] dd. 9 July 2004) also inserted a provision comprising two principles into the ITC. Article 185 § 2, a) of the ITC introduces the, "at arm's length," principle, which entails that where two companies are, in their commercial or financial relations, linked by conditions agreed upon between independent companies, the profits that one of these companies would have made without these conditions, but not because of those conditions, may be included in the profits of that company. Article 185 § 2, 6, for its part, provides for the principle of correlative adjustment, which "corrects" the previous principle.

Article 207, paragraph 2 of the ITC opposes any deduction or compensation (by way of investment-related deductions, tax losses and so on) on that part of the results of the tax period that are (notably) generated by abnormal or gratuitous advantages. Such advantages may be derived, directly or indirectly, from a company located in Belgium or in a country other than the country where the company in question is located and with which the company in question has a direct or indirect link of interdependency. The purpose of this provision is to prevent a company moving profits generated by one company to another company so as to allow the other company to offset the profits by means of a physical deduction (definitively taxed income, earlier tax losses, etc.).

Article 54 of the ITC establishes a presumption under which certain types of payments (interests on bonds or loans, royalties for the right to use patents, manufacturing processes or other similar rights or fees for services) paid or granted to non-residents (or to foreign establishments of foreign companies located in tax havens) are fictitious or excessive. Thus, article 54 of the ITC deems that payments of this type are not deductible professional expenses unless the taxpayer proves that the payments correspond to real and genuine transactions and do not exceed the normal limits.

Following the enactment of a law of 29 March 2012, Belgium has tightened its regime aimed at combating the undercapitalisation of companies. This regime limits the deduction of interest on loans when the relationship between funds borrowed and the company's own capital is too disproportionate. Before the law of 29 March 2012 came into effect, interest on loans like these was not deemed to be professional expense if the beneficiary was located in a country that operated a tax system that was considerably more favourable than the Belgian tax system and if the amount of the loans (other than bonds and comparable securities issued in a public offering) exceeds by a factor of seven the sums of the taxable reserves at the beginning of the taxable period and the capital released by the end of this period. This new law reduced this ratio of 1:7 to 1:5. But that ratio will henceforth apply to any loans taken out within a group of companies and is irrespective of the type of loan involved. However, a special derogation for so-called cash-pooling companies, i.e. companies that ensure the centralised management of cash within a group, has been provided for.

The system of definitively taxed income (DTI) referred to in articles 202 and 203 of the ITC was introduced into Belgian tax law to stamp out certain adverse effects in relation to tax on corporate dividends. These are in fact at risk of being subject to a cascading tax if the shareholders of the company paying out the dividends are themselves companies who remunerate their own shareholders. Thus, a system that prevents this cascading taxation was put in place. Under this DTI system, if the dividend is taxed at the base, it will pass through all the other companies without being subject to tax.

However, various conditions must be met before these dividends can qualify for the DTI system, one being that the dividends must come from a company that is liable for corporation tax or a comparable tax. Definitively taxed income can consequently not be deducted if it is attributed or paid by a company that is not liable for corporation tax or a comparable foreign tax or which is located in a country where the provisions of common law in matters of taxation are considerably more favourable than in Belgium, i.e. in a tax haven. The code also provides for a number of other exclusions.

Note should be taken of the measure, listed under point 10° of article 198 of the ITC, introduced under the Programme Act of 23 December 2009, which compels companies to declare any payments of minimum EUR 100,000 if they are directly or indirectly issued in favour of persons located in a tax haven. In addition to this obligation to produce said declaration, the taxable company targeted by this provision must also be able to prove, by any legal means, that any such payments issued feature, "*within the framework of actual and genuine transactions*," and were made, "*to persons other than artificial constructions.*" If that proof is not furnished, the expenses in question may, aside from being non-deductible, also be subject to a penalty of 309 %, as provided for under article 219 of the ITC.

The impact of EU and OECD law

Towards the demise of Belgian banking secrecy?

In line with European Union directives and OECD recommendations to promote greater fiscal transparency and intensify the exchange of information between tax authorities, Belgium did respond by adopting a number of concrete legislative measures. The most newsworthy of these is undoubtedly the measure that aims to stamp out banking secrecy.

Various amendments to the Income Tax Code have been introduced to allow banking secrecy to be dispensed with in cases of suspected tax fraud and when there are plans to resort to a risk-based assessment. In this context, a central contact point within the National Bank of Belgium was set up in 2011, tasked with recording certain details, which the financial institutions are henceforth obliged to disclose about their clients (the identity of clients, account numbers and contracts). The information thus collected can be checked by the tax administration in suspected cases of tax fraud or if the tax administration is contemplating resorting to taxation on the basis of signs and indicators of affluence.

A Royal Decree of 3 February 2014 furthermore gives banking and lending institutions access to the records of the national register of natural persons to ensure that the information at this central contact point is registered correctly. [56] A doctrine at large in Belgium is concerned that these recent legislative changes are merely a prelude to the compilation of a general wealth registry.

[56] At that, it must be added that taxpayers are also obliged to specify whether they have any bank accounts abroad, and where, when they are filing their tax returns.

The exchange of information

In its article 338 of the ITC (and in equivalent provisions of inheritance law and registration law), Belgium almost fully transposed the European Union's Savings Directive. The scope of the system of exchange of information was actually widened in the Belgian legislation because it does not only refer to persons with a legal personality but also to any legal constructions such as trusts, investment funds, civil-law partnerships, not to mention foundations. Moreover, article 338 of the ITC provides for the automatic and spontaneous processing of information in addition to the exchange on request that has been in place for a few years now and which is governed by internal rules of procedure.

This automatic exchange of information, which came into effect on 1 January 2015, and which relates to tax periods commencing on 1 January 2014, concerns persons residing in other Member States who have received certain types of income and capital. The assets targeted by this automatic exchange range from anything from the salaries of workers or directors, the proceeds of life insurance policies and pensions to property and the income generated by said property. The so-called spontaneous exchange the Belgian authorities can engage in refers to any information about suspect transactions that imply a loss of Belgian taxes. By way of example of suspect transactions, we can cite intragroup profit transfers presumed to be fictitious. This exchange of information Belgium implemented recently also aims to promote greater transparency in taxpayers' assets.

Conclusion: from the fight against tax fraud to a "tax contract"

Possible actions

Is Belgium adequately equipped to deal with all forms of tax fraud or tax evasion? Is the legislative arsenal outlined here complete or should it be improved or amended? Does the Belgian tax administration have enough means of action at its disposal to combat tax abuse?

For starters, we feel that a set of legislative or administrative rules that list the transactions that are likely to fall under the general anti-abuse provision would be welcome. A list like that which already exists for matters relating to indirect taxation would serve as a guide to the Belgian taxman and would offer words of caution to any taxpayers contemplating an incriminating transaction. In reality, the most important changes needed cannot merely be confined to the Belgian domestic sphere but must essentially be dealt with at European level.

In the face of globalisation, which opens the door for tax bases to be moved around frequently, in the face of the complexity of uncooperative jurisdictions who refuse to play their part in the game of fiscal transparency and who accentuate fiscal competition, we feel that some initiatives aimed at stopping certain fiscal erosion mechanisms might be in order. One of the first measures would be to further intensify the fiscal cooperation between Member States by developing a more direct system of information exchange.

A more coordinated approach to the actions of EU Member States with a view to combating tax fraud is also desirable. These exchanges could take the form of bilateral or multilateral political agreements covering an increasingly broader range of capital or income or by the strengthening of the means to help states recover taxes. These means remain underdeveloped and the rate of recovery is extremely poor.

The Member States could also step up their fight against any form of abuse of the double taxation conventions in a concerted fashion. On a regulatory level, Belgium, in collaboration with the other Member States, could defend the principle of a harmonisation of the term, "*purely artificial arrangement*," which we find in case law of the Court of Justice of the European Union and which aims to combat all forms of tax abuse. So far, this term lacks precision and is affected by variable interpretations. European rules that define the term of a common consolidated tax base should be transposed and implemented swiftly. This would facilitate the fight against all forms of indirect profit transfers and, at the same time, eliminate fiscal competition and the losses linked to an aggressive transfer pricing policy between companies located in different Member States.

Tax compliance and legal certainty

Necessary as it may be to step up all the measures to tackle harmful tax evasion, it is equally important not to violate taxpayers' most elementary rights. The desire for greater fiscal transparency should not lead to calling into question the legal certainty every citizen is entitled to or to fiscal injustices. New tax governance does not go hand in hand with the gagging of taxpayers or with violating the idea of freedom to choose the path of least taxation.

Of course, it cannot be disputed that the taxman is entitled to apply all the tax laws and to ensure that taxes are collected correctly, but it must be remembered that he must do so within limits that are acceptable and reasonable. As Professor Baltus wrote, *"an administration can only use its powers to attain the objectives it was granted*

these powers for and must tailor its actions to these objectives". [57]

Scrupulous compliance with the tax laws furthermore implies that the legislation is also intelligible. The fact is that the tax legislation, and particularly Belgian tax laws, has become frighteningly complex, leading to errors of interpretation and blatant circumvention. This is obviously not a plea for a naive simplification of the tax legislation. Besides, simplification does not necessarily lead to legal certainty. Behind every law there are social and political challenges that contribute to its complexity. Rather than simplifying them, fiscal texts should be made more intelligible.

The Oxford English Dictionary defines intelligible as, "that what can be easily understood". In the art of poetry, Boileau wrote: "*There are certain minds whose sombre thoughts are by a thick cloud always blocked; The daylight of reason never could shine through. Thus before learning to write, learn to think. (...) That which is well conceived is set forth clearly, and the words to say it come easily.*". Fiscal texts are often highly confusing. Additionally, the process of writing laws or circulars seems to be disconnected from the concrete process of implementing this legislative or regulatory work.

It becomes indeed difficult, not to say impossible, to apply texts that were hurriedly thought out to begin with. That is where the paradox lies. While it is necessary to promote greater tax compliance and to compel citizens to follow mandatory rules, it is equally important to provide the latter with the means to understand the reason for and the scope of the fiscal standard, if we want them to consent to it. This consent also implies a commitment from the state to guarantee legal certainty and stability. We should therefore work towards a tax contract, a kind of pact between citizens and the state, where each party is a winner, where, I, the citizen, agree to comply with the tax system imposed on me provided that it is clear, fair and efficient. "*When it comes to tax, the freedom of the people means everything,*" exclaimed the revolutionist Barère. To get taxpayers to comply with all the existing and future anti-abuse measures, they must first of all enjoy a legitimate sense of freedom.

[57] Marc BALTUS, Principes de droit fiscal (Principles of tax law), Ecole Supérieure des Sciences Fiscales (ESSF) course, 1992, p 37

Why the first World Tax Summit must take place in July 2015

A joint contribution by Oxfam International's European Union office

Oxfam International's European Union office in Brussels works to influence key decision-makers to ensure that EU policies affecting poor countries have a far reaching, positive impact on the lives of those most in need. Our work spans numerous policy areas including food security, climate change, development policy and finance, and the provision of humanitarian assistance to victims of conflicts and natural disasters.

The EU office works together with Oxfam's eight European affiliates in France, Germany, the United Kingdom, Ireland, Italy, Spain, Belgium and the Netherlands. We also join forces with allied NGOs and civil society organizations. Winnie Byanyima is Executive Director of Oxfam International.

We are living in fascinating times

High profile tax scandals

Over the past few months, tax dodging scandals have multiplied at an astounding rate. European and world leaders may have claimed in the past that banking secrecy was over and proclaimed the end of tax havens, but the overwhelming scale of recently revealed tax scandals presents a very different reality.

At a time of budget austerity in almost all European countries, there is a broad consensus on the limitations of current fiscal architecture and the need to find new solutions to fight tax dodging. Companies have been grilled over their tax-planning strategies by national and international politicians. The European Commission opened investigations against Luxembourg, the Netherlands and Ireland over four alleged cases of illegal state aid in the form of tax deals for specific companies. Investigative journalists revealed the negotiations of secret 'sweetheart' tax deals between large companies and Luxembourgish authorities on a massive scale. Developing countries have raised their voices on the need for fairer international tax rules and for multinationals to pay their fair share of taxes where they have real economic activities. G20 leaders have validated the action plan and the first set of mid-term measures proposed by the Organisation for European Cooperation and Development (OECD) –the so-called Base Erosion and Profit Shifting (BEPS) action plan.

Amongst all of this upheaval, citizens have expressed their views that they have had enough of tax dodging, and the decision-makers they elect can no longer turn a blind eye or be complicit in such socially damaging schemes.

Public perceptions of taxation are changing

Taxation is no longer being seen as the 'necessary burden' everyone has to suffer, but as a fundamental part of how to build a more equal and socially responsible society. Therefore, strategies and tricks by the richest individuals and companies to minimise their tax bill – whether legal or illegal – are no longer tolerated by the average citizen. With this new attitude in mind, the reaction of Starbucks to critics of its tax-planning scheme in the UK (to offer to pay a voluntary contribution to the tax authority) shows corporations' awareness of the changing public sentiment towards tax and demonstrates a certain sensitivity to reputational risk on tax issues.

Taxation drives development

Taxation is the most sustainable and predictable way for every country to finance its own development and finance essential services such as public health and education. But fair taxation is much more than just a financing mechanism; it is potentially also one of the best redistributive tools to fight inequality, especially when combined with well-designed public policies prioritising social investments. Finland and Austria, for instance, have halved income inequality thanks to progressive and effective taxation accompanied by wise social spending. However, most countries – especially the least developed ones - are not reaching their full taxation potential. OECD countries have an average tax to GDP ratio of 34 percent, while developing countries only reach a maximum of 15 to20 percent - a long way behind their richer neighbours. Oxfam calculated that if developing countries (except China) were to fill only half of their tax gap they could raise $1 trillion a year, enough to end extreme poverty 15 times over.

Tax dodging is causing a revenue gap

One of the obstacles to tax revenue collection and reducing the tax gap is the scale of tax dodging by wealthy people and multinational companies, who avoid their social responsibilities and place their own needs above those of the society that provides them with their wealth. According to Oxfam research, the twenty-eight Member States within the European Union lose on average (and as a very conservative guess) €120 billion a year to tax evasion by the wealthy and tax avoidance by big businesses. That is around five times the economic stimulus the European Commission is proposing to inject into its Investment Plan for the next three years to create more jobs within the EU.

Vast inequality

Following on from this, we live in a world of vast inequality. A world where the eighty richest people own as much wealth as the poorest half of humanity. A world where seven out of ten people live in a country where inequality has increased over the past thirty years. A world where citizens across the globe are demanding greater fairness and a change of international tax rules. It's time to even up the scales, and tax can play a major role in this.

Ongoing reforms and the need to go further

International response to tax scandals

Because of the public outcry after one too many tax scandals, G20 leaders have taken on the job of stopping corporate tax dodging by setting up new international tax rules. This was a timely decision on paper and long campaigned for by civil society organisations to fight tax dodging. The G20 therefore mandated the OECD to come up with a diagnosis report and an action plan, which led to the development of fifteen recommendations in the BEPS proposal to be completed by the end of 2015.

Concern with BEPS process

While supportive of the need for a comprehensive reform, Oxfam has expressed concern on the ongoing BEPS process for several reasons. G20 and OECD countries may represent ninety percent of global trade and therefore have a strong economic interest in fighting tax dodging by multinationals, but they represent only twenty percent of the countries on the planet and leave a third of the entire global population out of these crucial negotiations. Countries like Luxembourg and Ireland have a seat at the BEPS negotiating table, but Malawi and Paraguay - to name just two - do not have the same access to information and an equal say in this inherently global problem.

BEPS designed for developed economies

This results in BEPS being mainly a developed economies agenda, dominated by discussions on taxation of the digital economy, while other crucial aspects for developing countries are left out completely. Issues such as the taxation of the extractive sector, or the taxation rights on corporate profits in the country where they are generated versus the country where the multinational is based, never see the light of day despite being more important to the developing world.

More inclusive approach

The enlargement of BEPS negotiations – firstly to G20 but non-OECD countries like India, Brazil and China and more recently to ten developing countries like Senegal and Vietnam shows the demand for more inclusion. The need to both widen the scope of discussions and increase the number of countries participating is crucial to making sure this tax reform is seen as legitimate and owned by all states to be later implemented into their national legislation. But is that enough to ensure this process is representative, inclusive and democratic? Why accept just ten developing countries for half of the negotiating period and force them to fight their corner with their hands tied?

Lack of ambition

The other main concern is the lack of ambition of some countries to instigate a truly transformative tax reform from the beginning of negotiations. Promises of ambition and political rhetoric still claim the end of corporate tax dodging but half of the fifteen action points adopted in November 2014 leave big questions on the effectiveness of the BEPS action plan for developing countries. The agreed country-by-country report template, containing details on multinationals' economic activities will only be sent to tax authorities, leaving citizens in the dark about what companies are doing, all in the name of protecting sensitive information. And emerging countries' demands to include transparency on royalties or intra-group loans were left out of the final template. Most of the progress will rely on how this information will be exchanged, with a high risk that it will just be made accessible bilaterally, restricting developing countries participation as they don't

have enough tax treaties to exchange with rich economies.

Overall, the BEPS agenda is trying to patch up an ailing system when a completely new approach may be a better choice. In other words, OECD members refuse to depart from the 'arm's-length principle' and to look at different subsidiaries of the same company as a global entity that needs to be taxed in a holistic manner.

Close the loopholes

If we really want to stop multinationals using loopholes in the system to reduce their tax bills, we need to take this negotiation process much further than what is now on the agenda. The developing countries, particularly affected by corporate tax dodging because they rely more on corporate taxation to raise revenues, simply deserve better. This will not be achieved without a new paradigm in global tax governance. The lack of a global body to lead the design of international tax rules and cooperation mechanisms makes the OECD the only body with the capacity to embrace these issues, despite its membership not being universal.

The road to Addis

New Sustainable Development Goals

In parallel to the international tax reform led by more advanced economies, 2015 will be the year of the final negotiation of new Sustainable Development Goals (SDGs) and the agreement on their financing, under the guardianship of the UN. More specifically, the Financing for Development Conference in Addis Ababa in July 2015 is the first of a series of international conferences that will shape the world we live in for the next fifteen years at least. If no agreement is found on financing the SDGs, the UN post-2015 conference in September itself is at risk, along with the COP21 climate negotiations in Paris.

Financing for development

In the financing for development negotiation process, all countries participate on an equal footing and the first round of talks that took place in New York in late 2014 and early 2015 sounded promising – as is the zero draft outcome document published in March 2015. Bolivia, on behalf of the G77 (a group that now actually represents 130 countries) announced that, "*while there is increasing recognition of the central role of tax systems in development, the fact remains that **there is still no global, inclusive, norm setting body for international tax cooperation at the intergovernmental level**. There is also not enough focus on the development dimension of these issues.*" The group therefore calls for an intergovernmental body to allow all member states, including developing countries, to have an equal say on issues related to tax matters. This is in line with the UN Secretary General 'Synthesis' report published in early December, which also calls for an intergovernmental body on tax cooperation.

We need to learn from past experiences

Since 2002 calls for such a tax body have been deemed as a necessity to deal with international tax problems. Meanwhile, in a possible effort to buy time, rich nations agreed to the establishment of a committee of tax experts in the UN. However, this committee is only an advisory group of 25 experts acting in their own name, totally under-resourced and with no political mandate. It leaves the wealthy countries of the OECD to dominate rule-making on international tax despite representing only a tiny fraction of global states.

Twelve years later, it is time to accept what the majority of countries want and create a global body on tax issues with a broad mandate to go

beyond base erosion and profits shifting, in order to reform the broken international tax system, define arbitration rules and set sanctions. If we can do it for trade with a World Trade Organisation and for money laundering with a Financial Action Task Force, there is no reason why we can't do it for tax.

Time for a World Tax Summit

This is why Oxfam is calling for the organisation of a World Tax Summit during the Addis Ababa conference in July. This event, to take place when all leaders and high level representatives will gather in Ethiopia, is the perfect opportunity to ensure enough space to discuss vital taxation matters and to agree on a new global governance framework, with the potential to radically transform our lives in the future. Leaders must act on their own rhetoric and ensure tax works for the benefit of the many, not just the few.

The role of the European Union

The European Union needs to lead

In all of this, the European Union has an important role to play. Often seen as a pioneer in tax reforms, it needs once again to step up to the challenge and lead by example by not just defending the interests of rich nations. In the past, the European Union has played a role in the OECD and the G20 to call for international tax reforms and has been very supportive of the BEPS action plan. It now needs to recognise that BEPS is just a first step and that commitments for a broader set of tax reforms are necessary, placing all countries on an equal footing.

Strong link to European development policy

Enhancing domestic resource mobilisation in developing countries is one of the priorities of European development policy. However, the European Union has not yet acknowledged that one major obstacle to this mobilisation is its own tax policies. Correcting the international tax system is not only about aid money channelled to developing countries for capacity building or technical assistance to help them strengthen their tax administrations (which is necessary and complementary). It is mostly about policy coherence and removing the European legislation that lets the few get away with tax robbery unnoticed.

The EU needs to be a tax champion

If the European Union wants to remain the tax champion it claims to be, it needs to put in place the necessary measures to know the true locations of multinationals' economic activities, where they declare profits and pay taxes - to see if what they say matches what they do. The European Union needs to shed light on who owns companies or trusts to ensure these tools are not abused by criminals to hide tax assets and launder dirty money. But beyond transparency measures, we expect the European Union to lead with innovative proposals and greater tax harmonisation, such as mandatory legislation on a common consolidated corporate tax base (CCCTB), which will considerably reduce multinationals aggressive tax planning schemes. Clear sanctions against tax havens, and the companies using them, are long overdue. Credibility means cleaning your own house and not turning a blind eye to the tax-haven activities in Luxembourg and other European countries, and acknowledging the devastating impact on the developing world these activities have.

Will Europe meet the challenge?

With newly appointed European institutions, there is no better time for Europe to be on the right side of history. Internal and external leadership is crucially needed to clean the dirty tax practices of its own members and to set the standard internationally in Addis. Europe can

achieve this by sending its highest leaders to attend both the conference and a World Tax Summit in the form of a Ministerial discussion, which will change the international tax landscape with the promise to deliver for people and planet. Increasing inequality and unfair tax rules cannot be the main economic drivers of the next decade. It's time to level the playing field, and ensure that tax benefits both sides.

The European Commission's Role in Fighting Tax Evasion and Avoidance

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Heinz Zourek has been a member of the College of the EFTA Surveillance Authority and his portfolio contained state aid and monopolies, public procurement and free movement of persons. Between 1990 and 1993 he worked for the Confederation of Austrian Trade Unions as Director of the Economic Policy Department. Mr Zourek started his professional life in the Chamber of Labour in Vienna where he became Director for "External Trade and European Integration".

Most people recognise that tax is a necessary fact of all our lives, which allows governments to pay for the many essential public services we all enjoy. Nevertheless, few of us actually like to pay tax. Prior to the financial crisis, there was therefore a certain amount of tacit social acceptance of companies which structured their businesses in such a way as to minimise their tax bill. The financial crisis, however, changed everything. As countries responded to the crisis by increasing the tax burden on their citizens and cutting services, public attention began to focus more on how this burden was being shared across society. The media reported that many well-known and successful multinational companies were paying little to no tax and highlighted how they minimised their tax bills by exploiting the differences between countries' tax systems. Protestations by these companies that they were following the letter of the law largely fell on deaf ears. This was no longer enough. Many condemned these companies for acting unfairly and not paying their share, and demanded that governments act.

National governments, already cracking down hard on tax evasion, strove to combat this aggressive tax planning as well. But in a global economy, where there is free movement of capital, goods and services, unilateral solutions are unlikely to be sufficient. International measures are required. The OECD's Base Erosion and Profit Shifting project is bringing countries together to develop new initiatives to combat the problem. The European Commission fully supports the OECD initiative, and will work with the OECD and promote solutions, which are compatible with and strengthen the measures already proposed within the EU. The Commission will also take forward complementary initiatives better suited to action at the EU level.

The European Commission has a long history of fighting tax evasion and avoidance. The concept of fairness is at the heart of EU tax policies. In its role as guardian of the Treaty on the European Union and therefore the internal market, the European Commission has developed initiatives which focus on ensuring that companies are not unfairly penalised for operating cross border and are not taxed twice on the same profits. The Commission has also put forward proposals to combat tax evasion and avoidance. In addition to depriving Member States of significant amounts of tax revenues every year, tax evasion and avoidance distort competition between tax compliant businesses and their non-compliant counterparts, undermining the internal market principles. Likewise, aggressive tax planning means that the burden of taxation is not shared fairly in line with the choices made by individual governments. Countries then have to compensate for the aggressive policies of some businesses by increasing the burdens on others. Local businesses should not be placed at a disadvantage in trying to keep up with competitors able to exploit international tax differences.

Aggressive tax planning could also be considered contrary to the principles of Corporate Social Responsibility, given taxes paid by businesses can positively impact the rest of society.

The Commission reaffirmed its commitment to fairness in taxation in its action plan to strengthen the fight against tax fraud and evasion, published in 2012. The plan set out 34 actions which could be taken to enhance administrative cooperation and to support the development of the existing good governance policy, tackle the wider issues of interaction with tax havens and aggressive tax planning as well as other aspects, including tax-related crimes. Not only did the action plan highlight existing EU initiatives to reduce tax evasion and avoidance, but it also set out new initiatives which could help promote fairness. In particular, the Action Plan included recommendations on how to tackle aggressive tax planning. This recommendation suggests that Member States should reinforce their double tax conventions, to prevent them from resulting in no taxation at all. It also recommends the adoption of a common General Anti-Abuse Rule, under which countries could ignore any artificial arrangement carried out for tax avoidance purposes and tax instead on the basis of actual economic substance.

The action plan also put forward the Commission's intention to propose new legislation to close loopholes in the Parent Subsidiary Directive, which were resulting in double non-taxation. It is a credit to Member States that amendments to the Parent Subsidiary Directive have already been agreed placing them on a stronger footing to prevent double non-taxation. This demonstrates Member States' willingness to act to ensure fairness in the tax system.

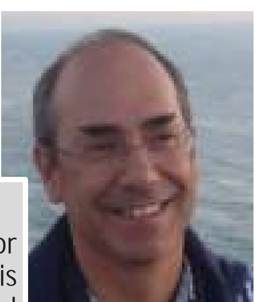
The action plan largely focuses on limiting both companies' ability to evade taxes and their ability to exploit inadvertent loopholes and gaps between international tax systems. However, it also stresses that national measures, which promote tax shopping by citizens and business, are unacceptable. Since 1998, the Commission has supported the work of the Code of Conduct group, in which Member States assess each other's tax regimes to identify harmful tax measures that could distort competition. Harmful business tax measures are those that provide for a lower level of taxation than normally applied and which may affect the location of business within the EU. This group enforces the commitment of Member States to abolish existing harmful measures and refrain from introducing new ones.

Since the group was established, over 400 tax regimes have been assessed within the EU. Around 100 of these were considered harmful, and have been eliminated or changed.

The Code of Conduct group is key to promoting fair tax competition within Europe and is therefore highly significant. The action plan is clear that there is scope, however, for it to be used with more ambition by Member States and expanded to address new cases of harmful tax competition.

Fair taxation is essential to preserve the integrity of the Single Market. A strong, well-functioning Single Market will help Europe return to prosperity and growth. The Commission has taken several steps to support and develop fair taxation. However, we are aware that there is always more that could be done. I therefore am grateful to the Federation of European Accountants for their efforts to publish this compendium of opinions on the future of taxation. My hope is that the articles in this publication will help move the debate on, and provide further insight into how countries can better define what constitutes social fairness in taxation, and provide refreshing new approaches to the way forward.

Working together for a better EU tax governance



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EU governance and civil society[58]

The principle of representative democracy is stated under article 11 of the Treaty of Lisbon. This provision sets the obligation for every European institution to allow citizens as well as their representative associations the necessary means to express their views in all fields of the European Union's activities. It also provides the legal framework for the creation of mechanisms allowing for a permanent, transparent and open dialogue to be established as well as for the launching of consultations with stakeholders on the subjects they deal with.

Many of these mechanisms have developed since the beginning of the 21st century, as part of an ongoing process of legitimising the governance of the EU, by giving more relevance to the participation of the civil society. They attempt to combat the democratic deficit the EU is accused of due to the non-directly elected nature of most of the institutional players (namely, the European Commission, the Council and the Court of Justice).

The institutionalised system of checks and balances on which the classic method of EU governance is based, known as the Community Method,[59] has been attracting criticism for being too distant from European citizens. Its lack of transparency and openness is again an extra element that may explain the increasing lack of public interest in the EU, as the most recent electoral turnout demonstrated.

These facts were acknowledged by the European Commission in its White Paper on European Governance[60], where it states that, "*Many people are losing confidence in a poorly understood and complex system to deliver the*

[58] The ideas expressed in this article are personal and do not necessarily represent the views of the author's organisation.

[59] The Community Method mainly consists of the Commission's exclusive right of initiative, the legislative and budgetary powers of the Council of Ministers and the European Parliament and finally the role of the European Court of Justice guaranteeing the respect for the rule of law, as described in the Commission's White Paper on European Governance (COM(2001) 428 final, 12 October 2001).

[60] COM(2001) 428 final.

policies that they want. The Union is often seen as remote and at the same time too intrusive." In order to renew the policymaking process, the Commission plans to promote greater openness, accountability and responsibility for all those involved. These principles, together with "effectiveness" and "coherence" constitute the five principles of good governance upon which the union should be based. Amongst the actions proposed, the Commission underlines the importance of a deeper involvement of civil society in the European debate and a need for a more effective and transparent consultation on policy shaping.

With this objective in mind – reinforcing a culture of consultation and dialogue – many expert groups have been created. In several cases these have been launched and funded by the Commission itself, integrated into the formal and informal structures of the EU's political institutions and they cover almost every policy area. Besides providing the EU with more knowledge and expertise, the formation of these institutionalised groups of interest was meant to give EU's political decisions the democratic legitimacy that they were lacking before[61].

More involvement versus more transparency

In its Green Paper on transparency[62], the Commission considered lobbying as, "a legitimate part of the democratic system, regardless of whether it is carried out by individual citizens or companies, civil society organisations and other interest groups or firms working on behalf of third parties." Lobbying was defined as, "all activities carried out with the objective of influencing the policy formulation and decision-making processes of the European institutions," and lobbyists refers to the persons carrying out such activities, namely public affairs consultancies, law firms, NGOs, think tanks, etc.

However, due to the critical response to the use of the term lobbying in the context of the aforementioned consultation (in particular, because of illegitimate lobbying practises), the Commission felt the need to stress again, in a new communication[63], that the definition in question, "*did not include any negative value judgement.*" Nevertheless, when setting the new legal framework for the activities of lobbyists it decided to call it a Register of Interest Representatives.

The register was established in 2008[64] and includes a voluntary register for interest representatives and a code of conduct. Its aim is to ensure more transparency about the identity and activities of lobbyists, as well as their level of resources. It should thus help to prevent and avoid illegitimate practises or privileged access to information or to decision-makers. On June 2011 a joint European Parliament-European Commission register (entitled the Transparency Register) was launched[65]. According to the 2013 report on the operations of the joint Transparency Register, it provides information about 6,000 organisations engaged in activities seeking to influence the policy and decision-making process. All of them have signed to a common code of conduct, accepting to bind themselves to a series of ethical principles,

[61] Greenwood, J. (2007) "Organised Civil Society and Democratic Legitimacy in the European Union", British Journal of Political Science, Vol. 37, pp. 333 – 357.

[62] COM(2006) 194 final of 3 May 2006 – European Transparency Initiative.

[63] COM(2007) 127 final of 21 March 2007 – Follow up to the Green Paper "European Transparency Initiative".

[64] COM(2008) 323 final of 27 May 2008 – European Transparency Initiative - A framework for relations with interest representatives (Register and Code of Conduct).

[65] http://ec.europa.eu/transparencyregister/info/homePage. This and other Internet sites mentioned in the current text were consulted in late July 2014.

which, if breached, may lead to the application of sanctions.

The future of VAT discussed at a broader scale

Another important area of governance reform concerns the involvement of interested parties in European affairs through public consultations[66], for which rules have been in force since 2003. The launching of consultations is mandatory for all Commission proposals for which an impact assessment is required. On the other hand, the publication of green books by the Commission is followed by an overall consultation process, opened to all stakeholders. All ongoing public consultations can be checked on the internet site: Your voice in Europe [67] where also former consultations and corresponding results can be found.

The importance of the outcome of public consultations on tax matters, in particular in the area of VAT, is growing. The Commission's communication published in December 2011[68], which establishes the areas where intervention is needed to reform the current common VAT system, takes stock of the input given by many stakeholders (businesses, tax authorities, universities and other members of civil society) when the latter responded to the 33 questions raised in the Green Book on the Future of the VAT System[69], launched one year earlier.

As a result of this exercise, two important decisions were taken in terms of involving representatives of civil society in the work concerning the future of VAT: the setting up of a group of experts on VAT and the setting up of the EU VAT Forum.

The VAT Expert Group (BEGV) was set by the Commission's decision of 26 June 2012[70]. The Group is composed of 40 members, either organisations or individuals who were appointed on basis of their applications and having been considered by the Commission as having a sound expertise on VAT[71]. The BEGV is chaired by a representative from DG Taxud (Directorate General Taxation and Customs Union) and provides advice to the Commission on the preparation and implementation of legislative acts as well as and other policy initiatives in the field of VAT. The Group follows the topics considered as priorities in the Commission's working programme for the future of VAT and has already addressed such subjects as the definitive regime, public authorities, the standard VAT return and the development of the One Stop Shop.

The EU VAT Forum was also created by a Commission decision on 3 July 2012[72]. It is formed by the representatives of the Member States' tax administrations and 15 delegates representing businesses or tax professionals, and it is also chaired by the Commission. The forum corresponds to a structured platform for dialogue between public and private stakeholders on cross-border VAT issues as well as on practical problems concerning the management of the current VAT system in view of improving its functioning. It can also be tasked with addressing other issues such as IT and

[66] http://ec.europa.eu/yourvoice/consultations/index_en.htm

[67] Idem.

[68] COM(2011) 851 final of 6 December 2011 – Towards a simpler, more robust and efficient VAT system tailored to the Single Market.

[69] COM((2010) 695 final of 1 December 2010 – Green Paper on the Future of VAT.

[70] 2012/C 188/02 – Setting up a group of experts on value added tax.

[71] A list of the members of the Group is available at: http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/expert_group/members_en.pdf

[72] 2012/C 198/05 – Setting up the EU VAT Forum.

combating VAT fraud. The forum has already developed work on proof related to the exemption of intracommunity supplies, the fight against fraud and cross-border rulings (CBR). The latter can be considered as the most visible achievement of the VAT Forum until now. It consists of a pilot-project allowing taxable persons to obtain advance rulings on the VAT treatment of complex operations with a cross-border element. The Commission published an interim report on the CBR exercise, including all the rulings issued by the countries involved, covering the period June 2013 to May 2014[73].

Alongside these two formations, the participation of businesses in EU events on VAT, either organised by the European Commission on its own or together with Member States is increasing, in the form of Fiscalis Seminars, meetings, conferences or workshops.

On a broader scale, the OECD has promoted an international platform for debate on VAT, entitled the Global Forum on VAT encompassing member and non-member countries, companies, consultants, EU institutions, think-tanks and academics. The purpose of the Global Forum is twofold; on one side it takes stock of the work and endorses the OECD International Guidelines on VAT/GST, on the other hand it promotes global cooperation and exchange of know-how and best practices on the implementation and administration of VAT systems or General Sales Taxes. The ongoing work on the guidelines is carried out by the OECD working party n° 9 where representatives from tax administrations, businesses and academics sit.

At national level, interest representation regulations have been introduced by some Member States of the EU while others are discussing the matter, in view of introducing more transparency and accountability into the political system[74].

The OECD has carried out a comparative study of 52 countries concerning consultation and engagement processes of the respective tax administrations towards representative bodies and tax intermediaries. It noted that only 60% of the revenue bodies surveyed reported the operation of a formal consultation forum for exchange with taxpayers' representatives[75].

Exploring alternatives to the traditional tax governance model

As demonstrated above, the reform of European governance is progressing. Alternatives are being explored in order to give more space to the representatives of civil society. The measures implemented seek to ensure more transparency around the participation of interest representatives in the different stages of the decision-making processes leading to common legislation. Consultants, lawyers and other intermediaries willing to disclose their identities as well as the interests they represent, register themselves under the joint Transparency Register and comply with a set of principles regarding their relations with the EU institutions and their staff. Registered entities are awarded with benefits and advantages such as the European Parliament accreditation that facilitates the access to its premises.

The participation of interest representatives in the different fields of EU governance has

[73] The following Member States participate in the CBR project: Belgium, Cyprus, Estonia, Finland, France, Hungary, Latvia, Lithuania, Malta, the Netherlands, Portugal, Slovenia, Spain, Sweden and the UK. More information on the CBR is available at: http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/vat-forum-note-information_en.pdf

[74] For an overview of the different mechanisms existing in the EU on this subject, see "The Annual Report on the Operations of the Transparency Register 2013", prepared by the Joint Transparency Register Secretariat, available in the TR site.

[75] See "Tax Administration 2013 – Comparative information on OECD and other advanced and emerging economies", Chapter 8 – Tax administration and tax intermediaries, pp. 253-272.

particular relevance in the social and employment domains, where the different stakeholders enter into agreements that can be further enacted as legal acts (known as Social Dialogue) or Member States agree on common guidelines remaining free to pursue them according to their national standards but accepting to assess practices in the light of peer review and EU benchmarks (Open Method of Coordination - OMC)[76].

In the area of taxation, a few changes have also been felt, although one cannot expect radical alternatives to the traditional method, since the treaties do not allow actors other than the institutional ones to decide on the matter. Nevertheless, the participation of the private sector in the consultation process preceding the presentation of proposals is expanding. As seen above, many stakeholders are participating in public consultations concerning the future of the VAT common system (particular examples are the consultations on the Green Book on the Future of VAT and more recently, on "Public Authorities" and "VAT rates") and tax experts as well as academics share their views and give their inputs to the Commission at organised events and joint working parties with tax officials. These developments should be considered as achievements in such a rigid area as taxation.

More could, however be done to promote joint work between private and public stakeholders and the European Commission is the best placed actor to promote and encourage it.

The EU VAT Forum is an interesting tool to foster dialogue and debate but it is not always clear what its objectives are. Moreover, some administrations consider it overlaps with the work of other (institutional) working groups and therefore do not fully engage with it, consequently reducing its effectiveness. In this respect, the work of the forum should clearly cover innovative matters, avoiding confusion with consultative bodies such as the VAT Committee or executive Committees such as the SCAC.

The work of mixed sub-groups needs also to be further encouraged in order to allow deeper exchange of perspectives and experiences and more mutual understanding. The outcome of this work should focus on the production of soft law measures such as recommendations, guidelines or best practises, capable of creating added value both to administrations and businesses. The OECD Guidelines on VAT/GST shows that joint work between actors with different backgrounds can be successful and have a broad impact.

Finally, doubtful feelings about the participation of private actors in non-decision-making processes in the field of taxation could be countered by ensuring transparency in relation to their identity, the interests they defend and the level of the relationship with institutional actors (for instance, their position concerning the Commission's public offers, studies and report assignments, etc.)[77]. The EU's Transparency Register could be used as a reference for this purpose.

[76] For alternatives to the Community Method see Scott, J. and Trubek, D.M. (2002) "Mind the Gap: Law and new approaches to Governance in the EU" in European Law Journal 8(1), pp. 1-18.

[77] The Commission stressed several times the principle that "with better involvement comes greater responsibility", launching an important number of initiatives that allowed the relations between itself and the interests' representatives to be opened to outside scrutiny (see COM(2001) 428 final and COM(2006) 194 final).

Automatic Exchange of Tax Information

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Automatic Exchange of Tax Information (AEOI) was brought into international focus by the introduction of the US Foreign Account Tax Compliance Act (FATCA) 2010 and expanded with the Common Reporting Standard (CRS). The CRS and AEOI as developed by the Organisation for Economic Cooperation and Development (OECD), is together with FATCA becoming a key challenge for financial institutions. The timelines for the implementation are challenging and the client due diligence and reporting requirements are extensive, resulting in increased pressure, both on operational and technical resources for the participating countries' financial institutions.

That said, most market participants agree that it is important to assist in increasing transparency and limiting tax evasion whilst preserving data protection legislation and the rights of the individual. It is in the shared interest of all countries and its residents to maintain the integrity of the fiscal system.

AEOI refers to the unprompted exchange of defined categories of data. Within the CRS these categories relate to financial account information. Unprompted exchange does not, however, mean that the information will be sent on a continuous basis but at a set date without the need for the receiving tax authority to request the data.

The nuts and bolts of it

The global standard from the OECD consists of the CRS, a model Competent Authority Agreement (CAA), and a detailed explanatory commentary accompanying the standard. The CAA is a contract that links the CRS and the legal basis for the exchange (this could for example be a bilateral tax treaty) and facilitates the actual exchange.

The CRS contains the actual reporting and due diligence standard. The financial institutions who are obliged to report data include financial institutions such as custodial institutions, depository institutions, investment entities and certain insurance companies.

The information in relation to reportable accounts to be exchanged within the CRS on an annual basis falls within six categories: interest, dividends, account balance or value, income from certain insurance products, sales proceeds from financial assets, and other income generated with respect to assets held in the account or payments made with respect to an account. Both entities' and individuals' accounts can be reportable and the CRS requires institutions to look through so-called passive entities to identify any reportable controlling persons.

Regulatory developments to date

Before AEOI there was EOI (exchange of information upon request). The OECD launched the Convention on Mutual Administrative Assistance in Tax Matters in 1988 and subsequently amended it in 2010. The Multilateral Convention on Mutual Administrative Assistance in Tax Matters provides for all forms of mutual assistance: exchange on request, spontaneous exchange, tax examinations abroad, simultaneous tax examinations, and assistance in tax collection, while also protecting taxpayers' rights. It provides the option to undertake automatic exchange of tax information (but only if the parties are interested in signing a separate agreement). On 13 October 2014 Monaco became the 84th signatory of the Convention.

In 2010, with FATCA the US government began to challenge the current system of "information exchange upon request". FATCA requires foreign financial institutions to provide information to the US tax authority, the IRS. Due to national legislation, countries were required to sign so-called Inter-Governmental Agreements (IGAs) in order to allow financial institutions to provide the US with data on US tax residents, including US citizens and green card holders.

At the behest of the G20 the OECD has developed its own AEOI standard which, unlike FATCA, is based on the tax residency principle but, like FATCA, requires the exchange of information on investment income, financial assets and account balances of foreign account holders.

The final version of the CRS was published by the OECD In July 2014. The standard, together with the explanatory commentary and the Model Competent Agreement, was endorsed by the G20 Finance Ministers and Central Bank Governors at their September 2014 meeting in Cairns.

At the Global Forum in Berlin in October 2014 the so-called Early Adopters Group of 51 OECD countries and jurisdictions committed to the early adoption of the CRS. Early adopters will automatically exchange information starting in September 2017. The US has so far not committed to the CRS and did not sign at the Global Forum.

The European Union's Member States are already exchanging some information as mandated by the Savings Directive (the EUSD). The EUSD was amended and agreed in March 2014. The EUSD currently requires AEOI on interest income. The March 2014 update extends AEOI to capture payments made through structures such as trusts and foundations. It also proposes to extend the scope of the Directive to income equivalent to interest obtained through investments in some innovative financial products as well as in certain life insurance products.

Following the completion of the CRS the European Commission proposed legislation to append it as an annex to the EU Directive on Administrative Cooperation (DAC). The incorporation of the global standard for AEOI was agreed by the European Council on 14 October 2014. The Council also agreed that the European Commission will need to prepare a proposal to repeal the EUSD, which currently mandates AEOI in the EU, in order to ensure that there is one global multilateral standard in place. All EU Member States are early adopters and will start exchanging information on 1 September 2017. This means in practice that financial institutions must start collecting the information to be exchanged from 31 December 2015 and perform due diligence procedures on clients from 1 January 2016.

The European Commission has also set up an expert group with members representing both industry and civil society. The purpose of the group is to provide advice that will allow the Commission to assist the Council and Member States and ensure that EU legislation on AEOI in direct taxation is effectively aligned and fully compatible with the OECD global standard on automatic exchange of financial account information.

Do we need two systems for the exchange of information?

Taxation of individuals is generally based on one of two principles: the citizenship principle and the residency principle. The US and Eritrea are currently the only two countries in the world that apply the citizenship principle whilst the rest of the world uses the residency principle when establishing taxation requirements.

The US taxes its citizens and resident foreigners on their worldwide income, and non-resident foreigners on their local income. US citizens residing in other countries may exclude some of their foreign income from US taxation, and take credit for income tax paid to other countries, but they must file a US tax return to claim the exclusion or credit, even if no tax liability results. US persons abroad, like US residents, are also subject to various reporting requirements regarding foreign finances. Should the US abandon the citizenship principle in favour of the residency principle, a single global system could become a reality.

How many systems do we really need?

Financial institutions are forced to maintain two systems for AEOI. From the perspective of the banking industry it is crucial that there are no more than two systems in place: FATCA and the CRS. Any additional systems, for example at a regional level or EU-level will create a non-level playing field between reporting and non-reporting institutions. It will also put an additional burden on tax authorities on top of what already promises to be a very extensive due diligence and reporting requirement. Multiple and inconsistent systems will also lead to fragmentation which, in turn, will result in conflicting requirements, additional costs and reduced effectiveness.

We have already established that, due to the difference between the residency and citizenship principle, two systems are required. The CRS poses challenges not included in FATCA that would become even greater with a proliferation of different systems. Consider, for example, the residency principle. In theory it sounds easy; an individual is taxed based on where (s)he resides. The difficulty for a financial institution occurs when it must ask its clients for their tax residency. It is possible for individuals to have homes in two or more countries, to tele-work from a destination of their choice etc. This makes it very difficult for customers to understand what tax residency means.

According to the CRS a new customer will need to complete a so-called self-certification when they open an account. This means that the customer must be able to understand the notion of tax residency in order to provide the correct information. It is therefore imperative that there is one system and a harmonisation of the definition of tax residency within all participating jurisdictions.

The need for clear definitions is not limited to tax residency however. Further clarifications of the definition of the data to be exchanged are needed in order to ensure that the data exchanged are meaningful for all participants. This does not mean that every aspect of the CRS must be standardised. How the data is processed and collected should be left to the financial institution to decide, as it has no bearing on the interpretation of the data and a standardisation of these aspects would simply result in increased costs and an inability of the financial institutions to leverage their existing infrastructure. Standardising other aspects, for example, self-certification, which will require the collection of different data depending on the national system for taxpayer identification, is also not necessary or even advisable, as it would potentially force national authorities to alter their national systems for registering taxpayers at a very high cost with little gain to society as a whole.

Outstanding issues before implementation

There are several issues on which the industry needs clarification before they will be ready to exchange information according to the CRS both within the EU and further afield. It is very important that national guidance is published as early as possible ahead of the implementation.

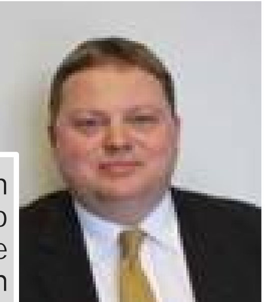
Data protection is another area where there are, at present, many question marks. National data protection legislation in several Member States does not sit very comfortably with the automatic exchange of financial account information with other jurisdictions. Many observers are asking whether it is preferable to break national data protection legislation or to fail to adhere to the CRS as the two currently are not compatible. Clearly the answer is that both should be adhered to, but an answer as to how this will be possible is needed urgently as the deadline for the first data exchange is approaching fast.

According to FATCA, taxpayers with a total value of specified foreign financial assets below a certain threshold are not reportable. If the total value is at or below $50,000 at the end of the tax year, there is no reporting requirement for the year, unless the total value was more than $75,000 at any time during the tax year. For US citizens resident outside the US this threshold is even higher. There is no threshold for individuals within the CRS. It is evident that the lack of a threshold will lead to a significant increase in identification of reportable accounts and a much larger data volume to be exchanged. This will most likely become a very relevant issue for the recipient tax authority who will need to analyse the data transmitted annually. One may question whether this is appropriate, and the compatibility with data protection legislation arises here too. It appears disproportionate to exchange information across jurisdictions on minimal amounts.

The way forward

The key message going forward is to avoid a proliferation of standards. The CRS should form the basis for global multilateral AEOI. It is very important that sufficient support is given to developing countries who wish to participate in AEOI, for example in regards to capacity building and data-mining. That said, existing national legislation and standards must be considered to ensure that financial institutions are not put in a position of having to risk breaking local or EU law. With the very tight deadline ahead of implementation there must be an open ongoing exchange between international organisations, national tax authorities and the financial industry. The common goal is to reduce tax evasion and tax avoidance. This can only be achieved by clear and harmonised rules applicable worldwide.

What to tax: time to shift tax systems from 'goods' to 'bads'?



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He works closely with decision makers in the European institutions, the EPC members and partners and the wider Brussels stakeholder community. Fabian regularly comments on current political and economic issues in the EU in the media and contributes to a wide range of debates, conferences and seminars and has researched and published widely on European economic and social policies.

Having lived through, and partially still experiencing, the most fundamental public finance, banking, economic and social crisis, the EU will take years, if not decades, to repair the damage. One of the crucial tasks is achieving fiscal consolidation in a low growth environment. While it is clear that too rapid public expenditure cuts can create a downward spiral – leading to lower growth, lower tax revenues and thus increasing rather than decreasing deficits – there will nevertheless be a need to find a better balance between spending and revenue in the longer term.

This balance cannot be delivered by expenditure cuts alone; taxation will also have to deliver greater revenues. Aside from greater growth, this can be done by increasing progressive taxation and by combating tax evasion and avoidance, although there are concerns that this might lead to capital flight and can distort incentives to work and invest.

In addition, there is also the question of new sources of revenue. Taxation in most EU countries relies predominantly on taxing labour/employment (income tax and social contributions) and consumption (VAT) as well as, to a lesser degree, capital (mostly capital and business income)[78]. All of these taxes have one thing in common: higher tax levels in these areas can be detrimental to economic activity, thus potentially lowering growth.

Taxation on other sources is relatively minor in comparison[79]. But there are potentially new sources of taxation which have not been fully exploited, which might have a positive effect beyond revenue-raising: taxing speculation (i.e. a financial transactions tax), taxing causes of climate change (carbon tax, petrol tax), addition taxes on products that might harm health (alcohol) and taxing property/wealth and inheritance, which could reduce inequality.

[78] Eurostat, Taxation Trends in the European Union, 2013 edition, p. 29 http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-DU-13-001/EN/KS-DU-13-001-EN.PDF

[79] For example, environmental taxes are, on average, only around 3% of GDP (Ibid., p. 41)

While there are already taxes on these, in most countries they are relatively minor sources of revenue and there is now active consideration being given to increasing some or all of these taxes.

But there could well be unintended consequences. There are a number of considerations that should be taken into account when additional taxation in these areas is considered:

- Fairness and public acceptance: for example, many people consider high inheritance taxation problematic, especially when wealth has been accumulated from already taxed income.
- Effectiveness: can taxation have the desired effect, for example, does a tax on certain potentially health-harming products really change consumption behaviour?
- Market distortions: will the free exchange of goods and services within the Single Market be affected and might there be an implication for international competitiveness, for example where energy taxation and thus energy prices are concerned?
- Administration: how easy and cost-effective is it to implement such a tax?
- Regressiveness: does the tax affect lower income groups more strongly?
- Coherence: how does a tax fit into the broader policy landscape, for example how does a carbon tax relate to the EU's Emission Trading Scheme?
- Impact on specific sectors and consequences for jobs and growth.

Thus, while there is significant potential, each tax needs to be carefully assessed on its own merits, including the negative impact it might have, and compared directly to other potential sources of revenue. In addition, despite political resistance of certain countries, there should be a serious consideration of whether any of these taxes could be levied at EU level rather than national level, especially due to the presence of significant cross-border effects.

Assessing the impact of the flat rate tax reform and the introduction of targeted tax relief in Hungary

A joint contribution by Ádám Balog, Gergely Baksa and Balázs Csomós

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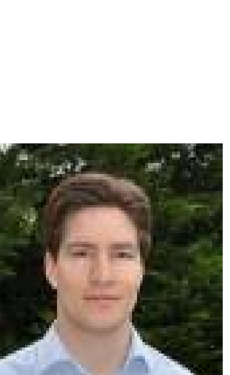

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He was Senior Advisor at the Tax Department of Pricewaterhouse Coopers Hungary and was the head of the tax policy and forecasting department of the Ministry for National Economy before he joined the MNB. He is a senior member of Heller Farkas College and has participated in the EC's Structures of Taxation Systems working group.

Introduction

In this paper, using an update of a micro-simulation model previously developed by the Central Bank of Hungary (MNB), we try to estimate the macroeconomic, budgetary and labour market effects of the introduction of the flat rate personal income tax system and the targeted tax relief of the Job Protection Plan in Hungary. Based on the results, the long-term macroeconomic effect of the measures appear favourable: the long-term budgetary impact is only HUF 38 billion (around 0.1 per cent of GDP), while GDP is set to rise by 3.6 per cent and the level of employment may increase by approximately 0.3 per cent. The results also indicate that the targeted tax relief in the Job Protection Plan will improve the employment rate more effectively than the previous approach, which used a general employee tax credit.

The taxes on labour income before 2010

The complicated labour tax system in place prior to 2011, placed an undue burden on people who were legally employed, and provided a strong disincentive to invest in human capital. At the same time the legislation included loopholes and provided easy opportunities for tax evasion.

In 2010 there were two tax brackets in the Hungarian personal income tax system: a rate of 17 per cent was applicable on the first HUF 5 million of the tax base (around EUR 16 000, and 160 per cent of the average wage) and a rate of 32 per cent on the tax base above HUF 5 million. The personal income tax was imposed on the basis of the super gross income, that is to say, the gross wage plus the employer's social security contribution. The rate of the employer's social security contribution was 27 per cent, which meant that the actual personal income tax rates were 21.59 per cent (17 x 1.27) and 40.64 per cent (32 x 1.27). In 2010 the employee tax credit[80] reduced the personal income tax liability of minimum wage earners to almost zero and it was phased out at a rate of 12 per cent around the average wage. The complicated system of the employee tax credit reduced the tax liability of more than 75 per cent of tax payers. Besides personal income tax, employees paid social security contributions (SSC) at a rate of 17 per cent up to the pension contribution ceiling and 7.5 per cent above that. In addition to the employer's social security contribution, employers also paid a 1.5 per cent vocational training contribution based on the gross wage.

The 2010 labour tax system was by far the most progressive one in the region and placed the highest burden on labour income compared to other countries, especially in the case of income received from extra work. The marginal tax wedge (i.e. the additional tax burden on the total labour cost as a result of a marginal increase in labour income) reached 64 per cent at the average wage and 67 per cent at the 167 percent of the average wage (see Figure 1). However, the burden of those with the highest income was less, due to the cap on the social security pension contribution. As a consequence, the tax system was regressive at the highest incomes.

[80] A tax allowance employed in the Hungarian personal income tax regime through which taxpayers could deduct a certain percentage of their income from employment from the amount of tax up to a specified ceiling. This was a relief targeted at alleviating the tax burdens of low-income persons.

Figure 1: The marginal tax wedge in Hungary and in the region

Source: OECD

The strong progressivity of taxes on labour income and high marginal tax rates imposed a disproportionately high burden on income received from extra work, which provided a strong disincentive to invest in human capital and a strong incentive to underreport earnings. In 2010, about 1.3 million people earned the mandatory minimum wage or less, out of a population of 3.5 million taxpayers and, according to studies, the wages of employees earning the mandatory minimum wage were underreported in more than 50 per cent of cases [Elek et al; 2012].

Furthermore, another disadvantage was that the tax system did not take into account the number of children in the household. The tax system in 2010 provided only a small amount of family tax credit for families with three or more children.

The introduction of a flat rate tax system

In order to tackle the above-mentioned problems, the government introduced a flat rate tax reform between 2011 and 2014. In the framework of the reform, a 16 per cent flat-rate personal income tax and a new family tax allowance was introduced. The super grossing principle (i.e. the inclusion of employers' social security contributions in the basis of personal income tax) and the general employee tax credit system were gradually phased out. As of 2013, the previously regressive social security system became flat and the cap on employees' social security pension contributions was also abolished.

As a result of the measures, the marginal tax wedge fell below 50 per cent in every income category (see Figure 1). The main objective behind the drastic decrease of the marginal tax wedge was to increase work intensity and reduce incentives for wage underreporting by reducing the tax burden on the income received from extra work for those in employment.

In case of low income earners the tax incentives were also reconsidered. The employee tax credit, which reduced the personal income tax liability to almost zero in the case of minimum wage earners, was fully eliminated in 2012. To alleviate the short-term negative impacts of that measure on the net income of low income earners, a compensation scheme was introduced and the mandatory minimum wage was increased by a significant amount. The compensation scheme provided tax credits in the employer's social security contributions for those employers who increased wages by at least an amount needed to maintain net income levels.

As a new permanent solution to incentivise the employment of the most disadvantaged groups of the labour market, the government introduced a new system of targeted tax relief in the framework of its Job Protection Plan by 2013. The main difference is that the tax relief is not generally available (i.e. their availability is not solely dependent on the income level of the tax payer) but target specific groups that are in the worst positions in the labour market. These groups are characterised by a low level of labour force participation and, based on the empirical literature, their activity and employment rate are usually more responsive to various tax incentives [Svraka et al., 2013].

In order to boost labour demand and to ensure more flexibility of wages around the minimum wage, these incentives were provided in employers' contributions. All the tax credits are capped but, contrary to the previous employee tax credit system, they are not phased out at higher wages, allowing marginal tax rates to remain low. According to the regulation, for gross wages of up to HUF 100 000 per month (EUR 330 per month, or around 50 per cent of the average wage) the employer's social security contributions (i.e. social contribution tax and vocational training contribution) can be decreased for:

- career-starters below 25 years of age;
- employees who are hired after a long-term period of unemployment (more than 6 months);
- employees who return to the labour market after child care or maternity leave;
- employees below 25 and above 55 years of age; and
- persons employed in unskilled positions.

The income of employees in unskilled positions, below 25 years of age, and those hired after a long-term period of unemployment are typically lower. As a consequence, in these groups the probability of wage underreporting is lower.

As a result of the changes, tax on labour income decreased to a significant extent. In order to offset the short-term budgetary effect of these tax cuts, the government gradually shifted the tax burden from taxes on labour to those on consumption and turnover. For example, the standard VAT rate increased from 25-to-27 per cent and further consumption and turnover type taxes were introduced (such as the insurance tax, the telecommunication tax and the financial transaction levy). This change is also important as such taxes are less distorting and, due to a more stable tax base, they constitute a more robust revenue source than income taxes.

Long-term macroeconomic and fiscal impacts of the measures

The model

To analyse the impacts of the measures we updated and amended the studies of Benczúr et al. [2012] and Benedek et al. [2012]. In this paper we focused only on the measures relating to taxes on labour income. However, you can find a broader analysis that includes further measures in the model in the paper of Baksay-Csomós [2014]. An in-depth description of the model used can be found in the paper of Benczúr et al. [2012]. In this paper, taking into account the space constraints, we provide only a short description of the model and instead focus on the simulation results.

The micro-simulation model is able to assess the labour supply responses to the measures on an individual basis, which is then embedded in a general-equilibrium neoclassical model of a small open economy. The steps of the micro-simulation are as follows. The first step is to simulate the labour supply response to the measures on an individual basis, based on a static micro-simulation. The labour supply response of an individual is calculated in two steps. First, the model calculates a probability of whether the individual enters the labour force based on the possible extra revenue from work and the cost of entering into work. The effect of the measures relating to the tax and transfer system on this probability is called the labour supply response at the *extensive margin*. Second, the model calculates the number of hours that the individual wants and is able to work based on the hourly wage that he can achieve, the average tax wedge and the marginal tax wedge. The effect of the measures relating to the tax and transfer system on the hours that the individual is willing to work is called the labour supply response at the *intensive margin*.

The micro-simulation runs on the 2008 Household Budget Survey (HBS), which is a representative sample of the Hungarian households, and includes information regarding the basic sociological characteristics and incomes of household members. It makes it possible to simulate more precisely the effects of the family tax allowance that is to be shared among household members.

After summing up the changes in labour supply on an individual basis, the aggregate labour supply shock is obtained. This is then fed into a long-run neoclassical model of a small open economy, which computes the effect on wages and the capital stock. After determining the 'general-equilibrium' wages, the micro-simulation is started again. This iterative process is continued until convergence is reached.

As described above, the model is capable of comparing long-term steady states of the economy. The difference between pre-reform and post-reform steady states shows the long-term macroeconomic effects of the measures.

Because of the relative simplicity of the model, it has a number of limitations. For example, in the model we assume that real wages are perfectly flexible in the long-run. Consequently, changes in the level of the mandatory minimum wage and the introduction of the wage compensation scheme have no impact on the long-run macroeconomic effects in the model. Furthermore, the consumption-savings decision of households is not addressed in the model and it is assumed that all disposable income is consumed by the households. As a consequence the VAT effect of the measures is probably overestimated and the personal income tax effect is underestimated in the results.

We present the effects of the measures step-by-step, first the measures related to the personal income tax and then the changes affecting the

employee and employer social security contribution.

The main changes relating to personal income tax

The majority of the above-listed measures regarding personal income tax and employee contributions have been examined by Benczúr et al. [2011] and Benczúr et al. [2012] previously. In addition to the measures that were discussed in those papers, we expanded the range of the measures with the extended family tax allowance and the abolishment of the cap on the employee social security pension contribution.

The results of the model are shown in Table 1 and Table 2, which consist of two panels. The top panel shows the macroeconomic effects of the measures: the percentage changes refer to the macroeconomic variables in comparison with a no policy change scenario. The bottom panel shows the static and dynamic budgetary effects of the measures.

The static effect shows the budgetary impact before labour supply or any macroeconomic adjustments take place. However, the static effect already includes the additional consumption tax revenues due to the additional disposable income. The dynamic effects take into account all adjustments that take place in the model (i.e. the labour supply response of individuals and the macroeconomic effects).

In the long run the changes in the personal income tax system have a significant favourable impact on the budget compared to the short run: the revenue decreasing effect reduces to one quarter. This is mainly due to the increasing effective labour supply as a result of the changes, while the available household income might also increase (Table 1).

Table 1: The partial effects of the measures regarding personal income tax

	Elimination of the spuer grossing principle		Introduction of the 16 percent flate rate PIT		Elimination of the ETC		Family tax credit		Total	
	static	dynamic	static	dynamic	static	dynamic	static	dynamic	static	dynamic
Macroeconomic effects	%	%	%	%	%	%	%	%	%	%
Effective labour		3,2		2,7		-0,3		0,2		4,1
Employment		1,5		0,5		-2,2		0,2		-0,3
Capital stock		2,6		2,3		-0,3		0,2		3,4
GDP		3,0		2,6		-0,3		0,2		3,8
Average gross wage		-0,3		-0,2		0,0		0,0		-0,4
Disposable income		7,1		4,9		-5,6		2,9		7,4
Budgetary effects	HUF billion	HUF billion	HUF billion	HUF billion	HUF billion	HUF billion	HUF billion	HUF billion	HUF billion	HUF billion
Personal income tax	-516	-467	-318	-273	539	536	-180	-180	-391	-341
Employee contributions	0	39	0	30	0	-3	-84	-83	-56	-8
Employer contributions	0	69	0	61	0	-7	0	4	0	91
Taxes on consumption	99	130	61	90	-102	-103	51	53	87	135
Taxes on capital	0	12	0	11	0	-1	0	1	0	16
Taxes on sales	0	13	0	11	0	-1	0	1	0	17
Transfers	0	17	0	5	-1	-20	0	2	0	-2
Change of budget balance	**-417**	**-186**	**-256**	**-64**	**437**	**401**	**-213**	**-202**	**-360**	**-93**

Note: The values refer to the annual net budgetary impact of the changes at 2010 price levels. The positive numbers refer to an improvement in the balance and the negative numbers represent a deterioration of the balance.

Based on the partial effects of the measures we can see that the cancellation of the super grossing rule, the introduction of the flat rate personal income tax and the extended family tax credit increased the employment and the effective labour supply. Therefore, the long-term dynamic effects of these measures decrease the revenue losses from personal income tax and the contributions. Furthermore, the same effect increases VAT revenues that stem from higher consumption due to the increased disposable income.

In the model a labour supply response at the intensive margin exists for high-income earners, which means that they increase their work in response to a reduction in the marginal tax rate. Therefore, as we can see in Table 1, the effective labour supply is most sensitive to the elimination of the super grossing principle and the introduction of the flat rate personal income tax, which reduces the marginal tax rate significantly for the higher income ranges.

On the other hand, the elimination of the employee tax credit dampens the economic activity. The tax burden of low-income workers who can fully benefit from the employee tax credit increases significantly, for which labour market entry probabilities at the extensive margin are relatively sensitive. However, for workers where the employment tax credit was gradually phased out, its elimination reduces the marginal tax rates and therefore provides an incentive to increase work. As a result of these opposing effects, employment is reduced by 2.2 per cent, while the effective labour supply and the output do not change significantly.

The effects of the targeted tax relief of the Job Protection Plan and measures relating to the social security contribution

In addition to the introduction of the flat-rate personal income tax system, Table 2 also takes into account the effects of the targeted tax relief introduced in the framework of the Job Protection Plan and measures relating to the social security contribution. The first column shows the effects of the 1.5 percentage point rise in the employee's social security contribution and the elimination of the cap on the employee's social security pension contribution (in addition to the measures relating to personal income tax discussed on the previous section). The second column shows the effect of the targeted tax relief introduced in the framework of the Job Protection Plan in addition to the previous measures. Thus, this column sums up the effect of all changes regarding labour taxes.

Table 2: Long-run effect of the changes relating to taxes on labour income

	Changes in the SSC in addition to the changes in the personal income tax (a)		All previous measures and the targeted tax reliefs introduced in the framework of the Job Protection Plan (b)	
	static	dynamic	static	dynamic
Macroeconomic effects	%	%	%	%
Effective labour		3,2		3,8
Employment		-0,7		0,3
Capital stock		2,7		3,2
GDP		3,0		3,6
Average gross wage		-0,3		1,1
Disposable income		5,0		6,3
Budgetary effects	HUF billion	HUF billion	HUF billion	HUF billion
Personal income tax	-391	-352	-391	-325
Employee contributions	112	160	111	192
Employer contributions	0	71	-167	-53
Taxes on consumption	54	91	55	115
Taxes on capital	0	13	0	15
Taxes on sales	0	13	0	16
Transfers	0	-6	0	3
Change of budget balance	**-225**	**-10**	**-392**	**-38**

Note: The values refer to the annual net budgetary impact of the changes at 2010 price levels. The positive numbers refer to an improvement in the balance and the negative numbers represent a deterioration of the balance.

(a) The extra revenue from the rise of the employee's social security contributions is close to HUF 150 billion, which is just enough to make the measures regarding the personal income tax and the social security contributions budget neutral in the long run. As a result of this measure, the effective labour supply decreases by 1 percentage point and employment only by 0.4 per cent compared to the measures regarding personal income tax (i.e. the last column of Table 1). The reason for this is that the 1.5 per cent rise of the employee's social security contributions affects all workers, while the elimination of the cap on the employee's pension contribution only affects high-income earners, whose labour supply reacts at the intensive margin to the changes.

(b) The targeted tax relief of the Job Protection Plan, on the contrary, affect employment more than the effective labour supply. This is due to the targeted nature of the measure: the introduced tax relief focuses on groups with low level of labour force participation (career-starters, employees who return from maternity, elderly jobseekers and so on). Furthermore, these groups are more responsive at the extensive margin to various tax incentives. The tax relief decreases employer social security contributions by HUF 167 billion in the short-run, while increasing employment by 1 per cent and the labour supply by 0.6 per cent in the long-run. The targeted tax relief can be used to decrease the employer's social security contributions; however, in the long-run the majority of the tax relief will increase employees' wages due to the long-term market adjustments. This is reflected in the significant, 1.3 per cent increase of disposable income. Since the only macroeconomic shock here is the change in the labour supply, the GDP and the capital stock adjust in proportion to the effective labour supply. The targeted tax relief contributes to the improvement of the effective labour supply, the GDP and the capital stock by around half per

cent in the long-run. This improves public finances in the longer term and decreasing the budgetary effect of the tax relief to HUF 28 billion (i.e. the difference in the dynamic change of the budget balance between the first and the second column), which is one sixth of the static revenue loss.

The results also indicate that the Job Protection Plan improves employment more effectively than the previous employment tax credit system. The targeted relief increase long-term employment by 1 per cent and worsens the budget balance by only HUF 28 billion in the long-run. In comparison, the employment tax credit system costs HUF 400 billion and could improve employment only by 2 per cent in the long-run. Therefore, it can be stated that each unit of budgetary revenue loss through the targeted tax reliefs of the Job Protection Plan achieves a larger employment effect than the previous employment tax credit system.

The long-term effects of the measures

Taking into account all measures discussed previously (i.e. the measures relating to taxes on labour income between 2011 and 2014) the budget balance decreases by HUF 400 billion in the short-run. However, as these measures improve all macroeconomic indicators, the long-term budgetary effect is only HUF 38 billion. The effective labour supply and the GDP increase 3.5–4 per cent, mainly as a result of the increasing labour intensity of high-income earners. Since the cuts in the personal income tax are concentrated at high incomes, they mainly increase the effective labour supply, and thus GDP, but not employment. However, the negative employment effect of the elimination of the employment tax credit is compensated by the targeted tax reliefs of the Job Protection Plan and therefore, the changes increase long-run employment by 0.3 per cent. The results also indicate that the Job Protection Plan improves employment more effectively than the previous employment tax credit system by achieving a higher employment effect when compared using an equivalent budgetary revenue loss.

Between 2010 and 2014 not only have the taxes on labour income undergone major changes, so to have other taxes as well. In this paper we focused only on the measures relating to taxes on labour income. However, you can find a broader analysis that includes further measures in the model in the paper of Baksay-Csomós [2014].

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The role of IT in tackling tax evasion and aggressive tax avoidance

A joint contribution by Prof. Dieter Kempf and Silke Stein

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Introduction: fair taxation – a question of perspective

A world with a significantly increasing volume of global economic relations also sees the number of market participants in multinational operations rise. Acting on an international market is no longer limited to a few, huge multinational companies. And thus, the various opportunities to shift sources of income between different countries are used more frequently by an increasing number of market participants.

Shifting of income sources or profit to low-tax countries does not necessarily mean that a company is committing a direct tax evasion. It can also mean that a company and its legal and tax consultants are just seeking to take advantage of a variety of legal fiscal design options, deriving from uncoordinated international taxation rules.

These options are possible because the current legal framework of international taxation can hardly encompass highly integrated value chains as well as new business and technology models in an adequate way. This enables businesses to benefit from regulatory loopholes.

Subsequently, this topic is intensively discussed in public. The International Consortium of Investigative Journalists (ICIJ) located in Washington is coordinating quite a lot of investigations in that area. And journalists all over the world publish the results of these investigations in newspapers and magazines.

The significant presence in the media indicates that a majority in society demands taxation to be fair. But what does fair tax treatment really mean and who can be the judge? In principle, actions are seen as fair if they follow the rules. These rules have to meet the, "reasonable expectations," of all actors according to the Gabler encyclopaedia. But honestly: do we have

a worldwide common understanding of reasonable expectations in our societies?

Tax evasion and aggressive tax avoidance result in a loss of an estimated EUR 1,000 billion per year for Europe's financial authorities (Die Welt, 2013). Legislators and tax authorities face the challenge of creating a legal framework for the grey area of aggressive tax avoidance in order to restrict the design possibilities for international tax avoidance techniques of high-profile multinationals. Recent revelations, such as the Lux Leaks scandal, however, show the ambivalence of their role. The smouldering financial crisis in Europe means that states are in urgent need of revenue, which in the end has led to even more intense international tax competition. However, tax competition is not a phenomenon that is predominately caused by these current developments.

A surprising new element is the kind of systematic cooperation between companies and tax authorities in search of tax optimisation through use of legal loopholes or by so-called tax preliminary rulings. Thus, it appears as an indispensable consequence that members of society (i.e. taxpayers themselves) demand a fair tax policy in accordance with ethical and moral criteria. As a result, they consider aggressive tax planning measures of business enterprises as equally unfair and damaging to society as actual tax evasion, even if it is by no means a crime.

This view stands in contrast to the business perspective: maximisation of profit through tax savings (as long as not illegal) is a fair economic objective. Seen from this perspective, one cannot blame managers of (multinational) corporations and consequently their tax professionals for executing efficient tax planning. All four participants – taxpayers, tax professionals, tax authorities and legislators – support the legitimate right to fair taxation. There are just different ways of drawing the line between the diverse interests of the players. Whether a more intense use of Information Technology (IT) could help to make tax evasion and aggressive tax avoidance more transparent shall be discussed in this article.

International efforts

The G20 finance ministers asked the Organisation for Economic Cooperation and Development (OECD) to draft a plan of action to fight creative (but legal) tax planning practices by multinational companies. The OECD's Action Plan on Base Erosion and Profit Shifting (BEPS) from July 2013 contains 15 action points that also focus on technical measures, amongst others on improving the exchange of information and data collection and analysis. Another path of action addresses the digital economy. Further measures are provided in the field of transfer pricing or the revision of the fiscal definition of a permanent residence. After completion of the BEPS project by the end of 2015, the accumulated knowledge shall result in a multinational agreement.

IT as leverage for further reforms of tax law

Information gathering

There is no doubt that fundamental reform of the international taxation system – such as a Common Consolidated Corporate Tax Base (CCCTB) within the EU or the introduction of taxation tied to the country of destination – would be appropriate ways to combat aggressive tax avoidance and profit shifting. At the moment, however, there is no evidence of a unified political interest in implementing these two reform proposals. Accordingly, they cannot be considered as short or medium-term options. Bilateral or multilateral activities seem far more promising, such as stricter regulations on additional taxation, the introduction of

restrictions on the deductibility of interest and license payments, the neutralisation of tax benefits for hybrid configurations and modifications of the transfer pricing policy. The availability and possibility of analysing mass data are the precondition for any of this to be effective.

In the past, a domestic financial administration hardly had any chance of clarifying individual tax issues for taxable persons or companies operating internationally due to the lack of possibility of obtaining information on tax matters abroad. By now, however, almost all countries have signed up for a tax information exchange with relevant financial centres. In particular, the automatic exchange of information between tax authorities within the EU will be extended in future (European Commission, 2015).

The European Commission has already developed several electronic databases and maintains them in cooperation with the tax authorities of the Member States. It established two platforms for the reduction of tax fraud and the improvement of information exchange – TIN Europe (a testing portal for EU-wide tax identification numbers) and VIES (a VAT Information Exchange System). In this way, important first steps have been taken to increase transparency. Both platforms are primarily verification portals that are mainly used for specific queries in case of suspicion.

Currently, tax authorities can only obtain accurate information on relocated property and income through painstaking additional research and enquiry. This could be changed significantly by the use of automated data interchange. Thus, for example, the Savings Directive provides a great possibility for automated mutual exchange of information on interest income between all EU Member States with few exceptions.

To allow an automated analysis of these data, the way of recording, transmitting, organising and converting the data is of particular importance. It is the starting point for an efficient and effective analysis in order to prohibit fraud and to plug tax loopholes. This is also the particular purpose of measure 11 of the OECD Action Plan (development of methods and schemes to collect data on earning cuts and gain relocations). It involves, for example, the evaluation of numerous existing data sources, the definition of new kinds of data to be analysed, and the development of new analytics based on both macro data (e.g. foreign direct investments and balances of payment) and micro data (e.g. from annual financial statements and tax returns).

Effective, forward-looking activities should usefully be based on a three-pillar model of prevention, detection and reaction in a coordinated manner:

- Prevention (manually and automated) reduces the risk of mistakes, non-balancing items and omissions and is especially applied in high-risk cases.
- Detection helps to uncover and correct mistakes. Typical examples of these procedures include the comparison of depreciation method and depreciation volume in connection with the appropriate asset or cut-off violations in sales transactions.
- Reaction covers all actions that are dedicated to treating cases of tax evasion and avoidance as well as the adjustments to the system to close loopholes.

Aiming for transparency and the disclosure of facts, one should distinguish between tax avoidance and tax evasion. However, there is neither an official, clearly stated definition nor a kind of common sense as to what constitutes acceptable tax avoidance.

Tax evasion is a violation of clearly defined regulations and thus much easier for IT to detect than (aggressive) tax avoidance. In the case of the latter, a company adjusts its products, services, legal formats, company structures or processes to the tax base. In practice it is often difficult to prove that tax evasion was the motivation for a specific transaction or a creative arrangement.

Traditional tax audits can no longer ensure the availability of timely, precise and comprehensive information. Furthermore, they only provide retrospective information by dealing with time periods in the past. The use of Big Data analytics, combined with risk-based approaches, could be used for predictive analyses of arrangements carrying a high risk of tax evasion.

As long as software is just used for disclosure requirements, even in multinational discovery systems, it will not be able to provide systematic prevention. To prevent or detect, i.e. constructions made for double levying of capital gains tax or to achieve zero taxation, a much broader analysis of cross-border data would be necessary.

From request to automatic exchange of information

According to the current OECD standard, information can only be requested if it is likely to be significant for taxation purposes, i.e. these enquiries can only be placed because of individual circumstances. To qualify as specific circumstances, there must be indications that a taxpayer moved assets or income to a foreign country.

In line with the proposed directive for an EU-wide VAT return from October 2013, the European Commission suggested to reduce the administrative burden for companies and to increase compliance with the regulations as well as to help tax authorities to work more efficiently (Centre of European Politics, 2014). It is planned that companies throughout the EU will be able to submit a declaration online. Furthermore, it will be possible to transfer data electronically with EU-wide interoperable advanced electronic signatures or comparable technologies. The proposal is currently under consideration in the legislative procedure. It remains to be seen whether it will be adopted.

The cooperation of fiscal authorities is organised in the Directive 2011/16/EU. Information is shared electronically via CCN-Net (Common Communication Network) – a platform developed by the European Commission for the digital transmission of data between tax and customs agencies. Standard forms are required in order to ease the process of transferring information. Besides the directive for the administrative cooperation of taxation, the following directives have been established which contain regulations for the automatic exchange of information within tax matters:

- Council Directive 2014/107/EU for the obligatory automatic exchange of information in tax matters: modification of the Directive 2011/16/EU and extension of the scope of application to include dividends, capital gains, other financial income, and bank account balances and, among others, the implementation of the OECD standards for the automated exchange of account information.
- EU Savings Directive (EUSD) 2014/48/EU: the directive shall prevent the avoidance of the Directive 2003/48/EG by dealing with interest payments via stakeholders located outside the EU. This shall be done by seeking more information about the economic owner from the paying agents, and then passing this information on to the respective fiscal authorities. Furthermore, beside interest, the new directive includes other substantially equivalent incomes, such as investment funds

or systems as well as benefits from life insurance contracts. The exchange of information between Member States automatically takes place once a year.

These propositions will have to go hand-in-hand with the guarantee of full privacy of taxable persons by secure and compatible data transmission systems. At the same time, the level of administrative expense for tax authorities and companies has to be reasonable.

The complexity of the matter and the necessity of a moral dimension, for example, with regards to the question of gathering the right amount of data for the investigation, are illustrated when debating secrecy in tax matters. The requirements of data comparison and analysis on one hand and the requirement to maintain a doctrine of tax secrecy are diametrically opposed. Norway and Finland are examples of Member States where there is no tax secrecy and all documents of the tax authorities are accessible by the public. This open handling of information would provide a breakthrough in the field of data collection by IT, and it would technically simplify the aim of more transparency. Nevertheless we have to critically question whether we want to imagine a regime of easily accessible tax data of individuals. At this moment in time, cultural differences and varying points of view are complicating the international efforts for a unified solution.

A goal-oriented, transparent collection and use of data, based on a clear legal regulatory framework on a European-wide level playing field are essential requirements for gaining acceptance and trust of individual taxpayers and companies. These are necessary preconditions for tax reform implementation. Only if those changes go hand-in-hand with well-defined rules of the game and without creating additional administrative burden, can one expect a broader acceptance of data collection and data analysis to achieve European-wide tax justice.

Information processing

Descriptive statistics

Nowadays, much of the required tax information is available in digital form. The foundation has been laid for integrated, fully digitalised processes. It sounds simple, but as so often the problems are in the odds and ends: data formats are incompatible; there is a lack of interfaces or (broadband) transmission methods, and so on. More and more federal authorities demand the electronic submission of financial data from companies. Formats such as XBRL (eXtensible Business Reporting Language) open up new possibilities to test and compare reported data sets. The "Statement on Auditing Standard No. 99 Consideration of Fraud in a financial Statement Audit (AICPA, 2002) have set the [auditing] profession in search of analytical tools and audit methods to detect fraud" (Durtschi, Hillison & Pacini, 2004). With this advancement in opportunity as well as obligations, digital analysis of financial reporting data is on the rise.

Descriptive statistics methods can be valuable tools in detecting irregularities in tax matters in existing data records. Data analysis enables financial authorities to obtain tangible and reliable results by identifying indicators across a wide range of (avoidable) fraudulent activities. A digital analysis of statistical key figures, a Benford's law test or a Chi-Square Test are three examples of the many possible methods that can be used to address these questions.

A first indication of irregularities could be measuring central tendencies and the dispersion of frequency distributions, concentration measures, ratios and index numbers (Betriebswirtschaftliche Forschung und Praxis, 2014, p. 143). In addition, the arithmetic average, the variance, and the standard

deviation, etc. can be examined. In this way, correlations between tax positions, income and revenue or deductible expenses may be analysed.

Benford's law is a theoretical probability distribution that is based on empirically observable phenomena. It describes the law of distribution for the digit structure in empirical data records. Benford's law predicts the probability with which a certain digit features the first, second, etc. position of any number. According to this provision, the digits are not equally distributed, e.g. the digit 1 appears in the first position more frequently than the digit 9. The figure analysis can be used in numerous data sets with a view to establish whether accounting irregularities have been committed.

The Chi-Square Test analyses the distribution of certain digits and is based on the knowledge that every human being has subconscious likes and dislikes for a specific digit or number. If certain digits appear more frequently than their statistical probability, this information can provide valuable evidence of a systematic deviation and thus of manipulation.

Forensic tax accounting

Forensic tax accounting identifies misrepresentation and assesses credibility by using psychological and text-analytical procedures. This form of analysis is particularly used to check doubtful or probably manipulated documents suspected of tax evasion. For example, documents are verified as to whether relevant information is aligned or information regarding different dates can be reconciled homogeneously. Another instrument of forensic tax accounting makes use of both qualitative as well as quantitative levels of detail in a proposition due to the existence of fraud. Psychology assumes that documents with truthful information contain more marginal and unusual details, which the reader is not to expect. In the case of fictional or manipulated facts, the testifying person can refer only to the abstract scheme (Betriebswirtschaftliche Forschung und Praxis, 2014, p. 163). Another criterion is the assessment of uniformity of the statement of a taxable person within a period; an examination is made to find out whether the information has been harmonised. An opportunity to check the homogeneity is the validation of the input VAT (Koehler, 2009, p. 47). It is calculated whether the acquisitions, goods receipt, and other expenses correspond on a value basis to a received input VAT deduction.

A number of forensic software solutions make it possible to identify improper business practices and to prevent fraudulent activities in companies, such as tax evasion. In addition to tax authorities, more and more companies are taking advantage of this new quality instrument as a system of prevention to detect internal (unwanted) misconduct.

The tools of forensic psychology and the knowledge that has been gained in the field of economic crime can also be applied to other areas. The structured examination being used in the process helps to define indicators that can point out tax evasion. These indicators may be used for suspicious cases of aggressive tax avoidance or to make aggressive tax avoidance more transparent or less possible. The crucial aspect in implementing this accounting method is not its technical feasibility. It is more the question of whether the increased visibility of aggressive avoidance is legally and politically desirable.

Examples of grey areas

Taxation is a sovereign right executed by the state. However, exchange between different countries and thus interaction of different domestic tax rules is leading to gaps and conflicts. In particular for multinational

companies, globalisation has opened up new possibilities to reduce their tax burden significantly and to operate in a so-called grey area. There are increasing complaints that this also leads to distortions of competition. The co-existence of residence taxes and withholding taxes in international taxation as well as the different national tax rates not only create freedom for tax structuring and differences in the effective tax burden, but also a tremendous structural complexity.

The following three examples illustrate the complexity of those constructions and identify the possible input of IT (in correspondence to the sanctions of the OECD action plan).

- ***Hybrid Design*** (OECD, 2014, p. 42)
  - **Case:** company B (in country B) is providing company A (in Country A) with a hybrid financial tool. In country B this is seen as a third party loan and consequently as deductible interest expense. Country A identifies it as equity and does not tax the dividend distribution according to a tax exemption rule for dividends.
  - Possible ways to respond:
    - Primary response: refusal of deduction as a business expense in country B.
    - Defensive rule: taxation in country A as long as there is no primary response practice in country B.
  - **Contribution of IT**: establishment of transparency with regards to the circumstances by cooperating and sharing information between residence states and states of origin.

- **Transparency and substance** (Baldamus, 2014, p. 13)
  - **Case:** implementation of beneficiary tax regulations for entities without substantial activities (known as the nexus approach). Company A is the legal owner of an intangible asset (e.g. intellectual property) and receives license income. It transfers this intellectual property to another company in a country where research and development (R&D) activities receive a favourable tax treatment. Under the nexus approach, the entire income of company A is subject to a tax advantage regulation which corresponds to the relation of qualifying R&D expense to total R&D expense needed to generate the immaterial asset. Thus the entire income of company A can be subject to a tax advantage.
  - Possible ways to respond:
    - Introducing a comprehensive, up-to-date information exchange between country of residence and country of origin.
    - Certifying economic activities dependent on business expenses (for R&D activities).
    - The countries involved agree on so-called patent-boxes, resulting in a modified nexus approach.
  - **Contribution of IT**: exchange of data to establish a consistent data foundation and transparency.

- **Transfer pricing**
  - **Case:** Audit on the transfer pricing documentation of a multinational company
  - Possible ways to respond:
    - Development of rules (or guidelines) for (timely) transfer pricing documentation with the aim of enhancing transparency for tax administrations, taking into consideration the compliance costs for business.
  - Contribution of IT:
    - Data collection (for example, directly from accounting records) and potential improvement of (monthly) reporting.
    - Improved transparency and access for tax authorities via country-by-country reporting

- Data analysis, e.g. to review the dealing-at-arm's-length principle.
-

Summary

IT can help to prevent and detect tax fraud or aggressive tax avoidance and can provide the necessary data to react, either by using intelligent retrospective or predictive data analysis, or by effectively increasing transparency. The critical eye of the public may inhibit a company from using all possible legal tax loopholes. However, we must realise that in a highly competitive world closing one loophole may open another. A spiral begins. That applies for profit-seeking companies as well as for budget-oriented states. Aggressive tax planning or avoidance would not be possible without tax competition between individual states. IT may in some cases even be a precondition for some of the measures and strategies of tax planning and tax avoidance. However, IT can never be the decisive factor in determining what is right or wrong, or what is illegal or immoral. This is decided by the respective regulatory frameworks of states.

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Tax Policy as a Matter of Good Governance

A joint contribution by Giovanni Bracco, Simon Perry, Richard Chadwick and Ray Farnan

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The contribution has been mainly prepared by Richard Chadwick. **Richard Chadwick** is a UK partner in PwC's Tax Risk Assurance team - he has specialised for over 15 years working with global multinational organisations on all aspects of tax strategy and governance helping them to embed tax effectively and efficiently across the business.

Good tax governance can no longer be considered in isolation from the wider business approach to governance, risk and controls. Therefore when thinking about what is good tax governance it is firstly important to understand how other risks and opportunities are effectively managed in the business.

PwC risk assurance framework

There are a number of ways these risks can be identified and managed within a business. The framework set out above is one way to do this and has been designed to help any organisation identify not only how it should assess where risk lies but also how to protect against this risk. It has three categories:

(1) the types of risk an organisation is exposed to;
(2) the approaches available to assess, mitigate and monitor these risks; and
(3) the lines of defence available to protect the company.

When thinking about the types of tax risk PwC has identified four different types which are shown on the diagram. But it is not enough simply knowing what risks are being faced; businesses need to understand clearly the alignment between what they are trying to achieve, and which risks to take, avoid and manage. Therefore the second level of the framework captures the elements that should be present in an organisation's model for managing risk - the risk, control and assurance continuum. Finally, there are four lines of defence which span aspects of a business from people, processes and technology through to the board, risk management and compliance functions, internal audit and finally, external audit. As you move across the four lines they become increasingly independent of the day-to-day operations of the business.

Tax management

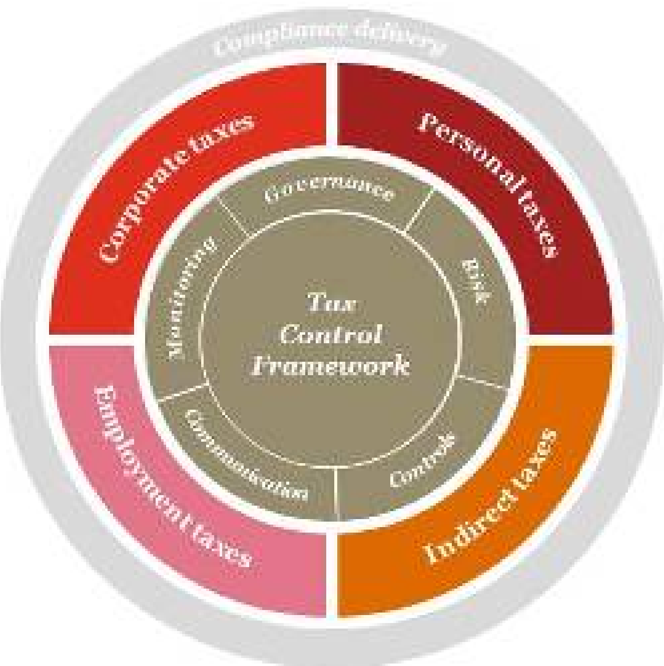
One way in which we see the above approach being applied is in the context of tax management, to help to ensure that an organisation is operating effective tax governance. Addressing each of these three areas in turn, together with what the organisation needs to consider, we will explore both the current tax environment and where we see the future of tax management.

Risk landscape – the current tax environment

We are living in a highly volatile tax environment. Tax is no longer simply a burden on a company's profits. Instead companies are under increasing scrutiny from a range of stakeholders to explain their tax affairs transparently. Tax authorities in member countries of the Organisation for Economic Cooperation and Development ("OECD") increasingly expect organisations to be able to confirm that tax risks are appropriately managed in a way that facilitates real time compliance. At the time of writing, the OECD is undertaking a project to alter the international tax landscape, through the Base Erosion and Profit Shifting (BEPS) initiative. All of these challenges have to be faced by business, whilst also managing tax risk and opportunity in a cost effective way.

Traditionally the role of tax professional has been to focus on providing practical answers to complex tax questions, for example in relation to corporate structuring arrangements. The new tax environment and need to improve the quality of financial controls has seen the role of the tax professional adapt and change. Senior management focus increasingly on how tax risk is being managed and how that aligns with the overall goals of the organisation. In particular, this includes a consideration of how tax management is aligned with the group's corporate social responsibility strategy, as well as its wider strategic goals. In short the risk landscape of tax has changed, and consequently the approach that is needed in the new environment to manage tax risk has also changed. As a result corporate organisations, tax authorities and professional service firms all increasingly have to adapt by combining both tax technical and risk management expertise.

Risk approach – Enhancing the management of tax in your organisation



In the new environment it is vital that an organisation's approach to tax management involves an understanding of the effectiveness of its tax operating model and tax control framework. Organisations need to understand the key tax risks inherent in their business, and be able to account for the effective and efficient controls in place to mitigate these risks and maximise opportunities. This will enable the business to develop a mandate for tax, and ensure that the organisation meets its wider strategic objectives, rather than risking being undermined by uncontrolled and misunderstood tax risks, which may create unexpected tax exposures.

Organisations that have met the challenges of the changing tax environment have recognised that the tax control framework and its components of governance, risk identification, controls, communication and monitoring are the key areas that must be focussed on to enhance the management of tax in the modern tax environment. The aforementioned components of a control framework were defined by the committee of sponsoring organisations ("COSO"), and whilst this is not the only accepted framework for defining a system of internal control it is the most widely used. Regardless of which specific framework is applied, the common threads which run through any well-managed tax control framework will consist of:

- strong tax governance with an agreed tax strategy that is in line with wider business objectives, reflecting clearly the expectation of customers, clients, staff and other stakeholders;
- an in-depth understanding of where the key risks lie within the business, including indirect and employment taxes;
- effective and efficient controls in place to mitigate identified risks;
- a clearly defined and transparent communications strategy setting out the

approach to managing tax internally and externally; and

- ongoing monitoring activities in relation to the above.

If an organisation has clarity around tax management, its tax strategy will be aligned to its business strategy and this will help to reduce reputational risk. External stakeholders will in turn be confident that the organisation clearly understands and is committed to delivering the tax strategy. It is then possible for staff in and beyond the tax function to be encouraged and inspired to take ownership of, and accountability for, the tax strategy, and embrace new ways of working based on key behaviours such as mutual trust, consultation and openness.

Risk response - four lines of defence

The above approach is good in theory, but how should an organisation be responding in practice and who in the organisation should take responsibility? There is more than one way to answer this, but we thought it useful to share our experience to date.

It is essential that there are strong lines of communication about tax controls, for both internal and external stakeholders, to allow an organisation to understand and analyse the tax control framework and current level of tax risk and opportunity management within the tax function. In responding appropriately, any organisation has to consider the following four lines of defence.

Although these are considered here in the context of tax, they apply equally to any risk management conversation that we have with clients in the context of the overall risk assurance framework.

1st line – People, processes and technology

The overall objective is to raise levels of self-awareness of how this first line of defence operates, before strategic objectives and the risk reward balance can be considered, to understand what action needs to be taken.

Finance or tax staff need to perform a current state assessment of their people, processes and technology, to determine which areas of tax management require an investment of time and effort because those areas may give rise to concern. They should also seek independent challenge from internal stakeholders or external advisors, as well as guidance on how to improve the area of tax management which requires enhancements, based on best practice and the experience of other organisations.

Remedial action may include in depth reviews and/or control redesign and enhancement in relation to a specific area of tax risk (e.g. short term business visitors, VAT master data, permanent establishment risk or transfer pricing). There should also be an analysis of how effectively the company's tax strategy has been communicated internally and externally and to what extent it is embedded throughout the organisation.

2nd line – Management and oversight

It is important for an organisation to identify the extent to which there is visibility and documentation of the key tax risks across the business, and the consistency with which risks and opportunities are managed across business units within the country of operation and, if relevant, cross border.

An ongoing review of the quality of tax management and tax compliance by individuals with tax risk management oversight responsibility is also an essential feature. This has particular relevance to the Senior Accounting Officer regime in the UK, under

which an annual certification is made to confirm that the organisation has in place appropriate tax processes and controls which underpin tax accounting arrangements i.e. tax return submissions are correct when submitted to HMRC. But more widely, it also requires an organisation to understand how the overall risk management framework can, and should, include tax.

3rd line – Internal audit

There is an increasing awareness amongst both tax authorities and corporate organisations, that tax has not previously featured in internal audit programmes. Where tax has been addressed by internal audit, the area of work to be reviewed is often determined by individuals or teams without both the required tax technical knowledge and knowledge of best practice control frameworks. Importantly there is now a need for internal audit practitioners to be supported by relevant tax specialists to develop the level of tax review. Typically in groups that are addressing this we see the following three approaches being taken.

Level 1: an overview report on the maturity of tax governance, risk and control framework across the organisation using a defined methodology.

Level 2: tax reviews focused on evaluating the effectiveness of the design of tax processes and controls in one or more areas of tax management.

Level 3: an in depth review to assess the operating effectiveness of tax controls in specific areas of tax management.

Each of the above approaches contribute to establishing an effective internal monitoring function, which in turn should ensure that key tax controls are operating effectively.

4th line – External assurance

The final and fourth line of defence is the external assurance. There is a range of ways in which good tax governance is held to account as part of the external assurance, and experience to date has included the following examples.

1. Groups are increasingly focussed on the immaterial risks which, whilst they do not prevent the signing of an audit opinion, can still present day to day challenges for the business to deal with in an efficient and effective manner.

2. Sarbanes Oxley is embedded from a US perspective, but building on that there is an increased focus on utilising tax controls and internal control frameworks to enhance the insight and rigour of the audit approach.

This area will develop over time and ultimately the extent to which an organisation's tax control framework is subject to external audit (outside the scope of a statutory audit) will depend how individual tax authorities approach cooperative compliance. One option would be for tax authorities to audit the operation of the tax control framework, which brings its own issues around independence and in particular resourcing.

Another option could be an objective international auditing standard on assurance provided over tax controls. This approach would create consistency and would be in line with other Internal Standards on Assurance Engagements (ISAEs) which are used for other types of audit performed on controls by external accountants. It would also be an option to introduce a system of self-assessment by the Executive Board of a company and/or the provision of independent assurance by internal or external auditors. Whatever the outcome, this is an important area which will change alongside the requirements of the international tax world

and should not be overlooked by corporate groups and the COSO-based tax control framework model provides an effective insight as to where tax risk management is headed.

Risk response – Tax management maturity model (T3M)

There are number of different ways in which organisations can respond to these issues but it can be particularly challenging to bring all the aspects together especially when considering the first three lines of defence. One such way that we have helped organisations respond is by using the PwC Tax Management Maturity Model ("T3M"). This is based on the internationally recognised COSO ("Committee of sponsoring organisations") risk management framework, as well as our experience of advising companies on effective tax management. By completing the self-assessment phase of the model, organisations will ensure that they have covered all five aspects of the organisation's tax control framework (as highlighted in the risk approach section above). This will help them to understand both the current and desired state of tax management, and will assist them to develop an action plan to achieve the organisation's strategic goals.

The format of T3M is structured by reference to the PwC building blocks of tax management, which comprehensively cover the COSO framework for internal controls. T3M uses five maturity levels to assess the current and desired state, i.e. the ambition level of maturity, across each area of tax management. We help organisations by challenging and guiding the ambition level, and this in turn shapes the recommendations and action plan for improvement. Each level of maturity is defined in line with the broad definitions that are used when an organisation assesses any internal control framework; initial (ad hoc and incident driven) through to optimised (standard procedures which are applied and enhanced continuously).

T3M is only one way to combine the above principles of good tax governance and thus enable an organisation to enhance tax management, but any alternative approach should adhere to the principles of effective risk management which underpin T3M. It is a difficult challenge to combine tax technical and risk management expertise. A number of organisations are dealing with this at present, and we believe that this will continue for a number of years to come. Organisations' response to the challenge is demonstrated by a shift in the skill set required of tax professionals in corporate tax departments, tax authorities and professional service firms alike. Increasingly tax technical ability has to be supplemented with project management, risk management and technological expertise.

Conclusion

So to return to the initial premise, there is a changing tax environment which requires organisations to adapt. We have observed changes in the way organisations and tax authorities approach tax governance, the rigour with which it is assessed and how recent changes will shape the future of good tax governance. The developments in financial risk management in recent years will, in our opinion, give a strong foundation on which to base the principles for good tax governance. We see the key challenge that many groups are facing is establishing the right balance of risk and reward, to ensure that the appropriate level of specialist resource is allocated to enhance tax governance in the organisation. Often assistance is required to build the business case for change if there haven't been historic tax errors or tax risks which have materialised to cause reputational damage.

What is clear is that tax is very much a business issue and tax strategy and risk appetite can no longer be set in isolation from the wider business, a very welcome integration which we consider will only continue and strengthen in the future.

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The Search For A Tax Ethic

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The need for a tax ethic

In recent years, the tax policies of corporations have come under the spotlight. There are many critics of tax avoidance, which is the use of loopholes to pay less tax without breaking the letter of the law. If corporations do too much to reduce tax liabilities, they are challenged by politicians and by the press.

Corporations can try to defend themselves on each occasion. They sometimes have good defences. But a corporation can also find it helpful to have an overall approach to tax planning, a tax ethic which sets out how it decides what to do. An ethic can guide decisions, to make sure they will be justifiable if they are challenged. A corporation can also publish its tax ethic, to show that it acts in a consistent manner and for good reasons, rather than simply hunting for the best tax-saving opportunities on each occasion.

A tax ethic of this kind governs the taxpayers, the corporations themselves. They are the ones who decide what to do, and what not to do. But professional advisers need to consider their ethics too. Is it acceptable for them to offer the most aggressive tax avoidance schemes to their clients? Or should they refuse to offer certain types of advice?

We shall mainly discuss tax ethics for corporations. But having done so, we shall set out a way to derive ethics for tax advisers from ethics for corporations.

What a tax ethic must do

A tax ethic must set out a general approach to the ethical aspects of decisions with major tax implications. What ethical guidance will a corporation apply when it decides how to structure new sources of finance, where to hold its intellectual property, or how to expand into new countries? An ethic might, for example, recommend that a corporation should attach special weight to the need for developing countries to secure their tax revenues. Or it might recommend paying a reasonable amount

in tax in return for using the educated workforce, and the infrastructure, of each country where the corporation operates. Or it might say that a corporation should take care not to pay so much tax that it would have to close some operations, and throw people out of work.

We should look for a tax ethic that sets out general principles, rather than one that works mechanically to give an answer to the question "what should we do?" on each separate occasion. Business life is too complicated for mechanical computations to give sensible answers every time. There needs to be space to exercise judgement. At the same time, the principles in an ethic need to be strong ones, and they need to be applied firmly. If they are weak, the ethic will give very little guidance. And if they are not applied firmly, the ethic will make little difference to what a corporation does.

There is another reason why the principles need to be strong and applied firmly. Part of the job of a tax ethic is to allow a corporation to answer those who criticise its conduct. Shareholders may criticise a corporation for not taking reasonable steps to reduce tax liabilities. Politicians, pressure groups and the press may criticise it for going too far in reducing its tax liabilities. If a corporation can show that it only takes decisions after serious ethical reflection based on clear principles, it is likely to have good answers to its critics. But if the principles are not at all demanding, or if there is no serious consideration of whether transactions might be unethical, critics will not be impressed.

Possible contents

If we list some possible contents of a tax ethic, it can help to give us a clear idea of our goal. The following list is only a small sample. Some of the items mentioned may be omitted, and other items, not listed here, may be included. The aim is only to lend some definiteness to the discussion.

(a) A corporation should arrange its tax affairs so that if information about those affairs appeared in the press, the corporation would be able to justify its actions by disclosing full details of all of its tax affairs, and then explaining the reasons for its actions.

(b) A multinational corporation should not use a tax scheme that succeeds only because tax authorities in different jurisdictions have limited rights to information, meaning that no one authority can see the full picture.

(c) A corporation should not use a tax scheme that would obviously have been blocked by lawmakers, if they had considered it when they were passing the relevant laws.

(d) A corporation should not exploit a developing country's economic weakness when negotiating what tax it should pay.

(e) Tax burdens should not be reduced to a level that could be regarded as taking advantage of a country's infrastructure, workforce or natural resources by not paying adequately for the resources used.

(f) A corporation should take care not to disadvantage its shareholders by failing to negotiate robustly with tax authorities on matters of fact that affect tax liabilities.

Sources of a tax ethic

A tax ethic should not simply be one that a corporation finds convenient. It will only help to justify a corporation's decisions, if its contents are themselves justifiable. We need to find some general approach to ethics that is widely recognised as sensible, and that can guide corporations in formulating their tax ethics. Fortunately, that is not difficult. On the other hand, no general approach is perfect.

Utilitarianism

One approach that is very widely accepted is utilitarianism. This is the view that we should act so as to promote the greatest happiness of the greatest number of people.

By itself, this approach is not however enough to guide a corporation. On the one hand, a corporation might recognise that the happiness of the general population required plenty of tax to be paid to fund schools and hospitals, and that the increase in happiness from paying it would be greater than the decrease in the happiness of the corporation's shareholders. Then the corporation should not try to save tax. On the other hand, a corporation might reason that the best way to increase the happiness of the population would be to have a flourishing private sector, with plenty of economic growth, and that the best way to achieve that would be to keep as much money as possible in the private sector. Then the corporation should try to save as much tax as possible.

Utilitarianism can also recommend conduct that looks as though it is completely unacceptable. Suppose that a corporation is desperately short of cash, and can only survive by making a false claim for a tax refund. If that would mean thousands of people keeping their jobs, instead of becoming unemployed in the middle of an economic depression, there would be a utilitarian argument for making the false claim. But most of us would still think that it would be wrong to do so.

Utilitarianism may therefore both leave a corporation without adequate guidance, and lead it astray. We should consider combining utilitarianism with another approach.

Virtue ethics

The idea of putting virtue at the centre of ethics goes back to ancient Greece, and particularly to the work of Aristotle. A virtue ethic does not give us a list of things to do in specific situations. Instead, it says we should have certain virtues, such as courage and honesty, so that when we find ourselves in ethically demanding situations, we act in ways that are appropriate, and that can be justified.

This looks ideal for our purposes. The emphasis on having virtues, and on thinking appropriately in each situation when it arises, gets us away from a mechanical procedure that would simply prescribe an answer. And we should also be protected against doing things which might seem good in utilitarian terms, but which strike us as wrong, like making a false claim for a tax refund so as to stay in business. We would instead see such actions as contrary to virtue.

Virtues are, however, usually thought of as virtues of individuals. It is individuals who are courageous, or honest. How can we extend this idea to corporations, which do not lead human lives?

We need to borrow from the tradition of civic virtue, a tradition that goes back to ancient Greece and Rome. It emphasises the fact that we need to behave in certain ways, if a society is to hold together.

Much of the emphasis in this tradition has been on forms of government, and on ensuring that people do not become subject to arbitrary power. For that reason, the tradition is also known as the tradition of republican virtue. But there is also a strand of thought that emphasises the virtues that are needed to make a society flourish. People must be willing to make their contribution to the good of their society.

We can use this strand of thought, but it was not developed for the modern business

environment, so we do need to modify it to suit our purposes. What follows does not derive entirely from the historical tradition that lies behind the notion of civic virtue. But we can still use ideas from the tradition to help us to justify contents of a tax ethic. We can use a concern with making a society flourish in two ways.

The first way is this: The virtue of honesty is one that needs to pervade the whole of society. If it is practised by individuals, but not by corporations, it will not have its beneficial effect of allowing us to interact without a constant fear that we may be cheated. We must all have dealings with corporations, and we need to be able to trust them, just as we need to be able to trust individuals. The level of honesty required goes beyond merely giving correct answers to questions that may be asked. It also implies not concealing information that is clearly relevant. This is not just information that is relevant to a specific transaction. It includes information that is relevant to assessing the character of a person, or of a corporation, so that we can tell whether we should have dealings with them. So corporations should not rely on concealment. This would justify items (a) and (b) on our list. (In relation to item (a), there might not be any requirement to disclose information before any questions were asked, but the corporation should make sure that it would be in a position to disclose complete information.)

The second way is this: A corporation should act so as to sustain an environment in which business can flourish. There are ways in which businesses have always done this, since long before tax became significant. It is, for example, essential that businesses stick to their contracts. One business will only agree to supply goods or services to another, if buyers nearly always pay the agreed price. It is clearly in everybody's interests if all businesses display the virtue of keeping promises, and they mostly do so.

We can extend the idea of sustaining the right environment to taxation. Corporations can only make profits in a society in which there is a stable currency, a system of commercial law, protection against theft, an educated workforce and infrastructure such as roads. So if an environment that allows business to flourish is to be sustained, corporations should make sure that enough taxes are collected to provide these things. This could be used to justify item (e) on our list. It would also justify item (f), because corporations will attract share capital more easily if investors expect that corporations will stand up to tax authorities. Every corporation that does not do so encourages officials to be unreasonable with other corporations.

This does still not give us all that we need. There are two main challenges, although the tradition of virtue ethics does suggest responses to both of them.

The first challenge is that we only have an argument for ensuring that enough tax is collected to provide some fairly basic services. This might be less than half of the amounts typically collected in modern welfare states. A response would be to say that it is part of virtue to accept the decisions that a society takes through democratic political processes, and not to subvert a political decision in favour of a particular size of public sector by avoiding tax. This could justify items (c) and (d) on our list.

The second challenge is that if what matters is to ensure that enough tax is collected, what would be wrong with a few corporations using avoidance to pay hardly any tax, so long as the other corporations paid their shares? A response would be to say that it is manifestly contrary to virtue to avoid one's own share of a burden.

The tradition of virtue ethics can therefore provide some guidance when formulating a tax ethic. It does not give us everything we would need. Utilitarianism also has a role to play,

because consequences of actions do matter. But the two traditions can be blended quite comfortably, as one reason why ways of behaving are virtuous is that they tend to have good consequences.

Duty, a social contract and fairness

There is a strong tradition that claims that an ethic should be based on the demands of duty. We have certain duties, such as duties of honesty or of helping people in need, and we should perform those duties, simply because they are our duties, rather than because of their roles in allowing society to flourish. We shall not try to use this tradition as the foundation for a tax ethic. If we think in terms of duties that it is right to perform, simply because they are duties, we need the duties to be very well-defined. And if duties are very well-defined, they are not likely to help us to decide what level of tax avoidance is acceptable. There is a well-defined duty to obey the law. But tax avoiders do obey the law, in their own calculated way. The question is, how far should they respect the spirit of the law? It is not easy to give a precise answer to that question, so it is not easy to formulate a duty to respect the spirit of the law that is specific enough to be issued to anyone as a command.

There is a connection between duty and the idea of a social contract, a hypothetical agreement between all of us on how society should be run. This tradition is very important in political philosophy. The idea is that if people can be seen as having made an agreement, they have a duty to abide by the agreement. For example, we have implicitly consented to allow elected governments and legislatures to make our tax laws. Then we should abide by those laws, and we should not seek to frustrate those laws by using clever tax avoidance schemes. We could extend the argument to corporations by arguing that if they choose to do business in a country, they implicitly agree to its social contract. If they do not like the contract, they should not do business in the country.

While this might be a valuable line of thought, we shall not pursue it here. One difficulty is the same as that which arose with duties. It is not clear how much tax planning would amount to frustrating the laws, so a rule precise enough to be a term in a contract could not be drafted. Another difficulty springs directly from the analogy with contracts. If a corporation makes a business contract, it must abide by the precise words of the contract. It is not obliged to do more than the contract says, for example by observing the spirit of the contract. So if the social contract argument were to be used against the tax avoider, we would need an argument to explain why tax laws, considered as contracts between taxpayers and the state, were different from business contracts in this respect.

Finally, there is the notion of fairness. This can be taken in two senses. First, there is a notion of fairness that is linked to the idea of a social contract. If we have entered into a social arrangement, it is only fair that we should comply with its demands on us. When it comes to tax avoidance, this takes us back to the difficulties that we have just discussed. What are those demands? Do they really go beyond what the letter of the law says, and if so, how far beyond it? Second, there is fairness in the sense of paying one's fair share. This would seem to make a case against tax avoidance. After all, how can it be fair for a rich corporation to get out of a tax burden? Other, poorer, taxpayers will have to pay more. But things are not quite that simple. If a corporation reduces its tax burden, the shareholders who benefit are likely to include pension funds and other investment funds that hold the savings of people on modest incomes. And in any case, the idea of fairness is too vague to allow us to reach any agreement on what a fair distribution of the tax burden would be.

Justifying a tax ethic

We have recommended a blend of two general approaches, utilitarianism and virtue ethics, and we have discarded some others. Does this leave us vulnerable to challenges from people who prefer those other approaches?

It does not.

If we can find respectable sources of guidance to use when formulating a tax ethic, and if we find that the ethic yields decisions that are widely regarded as sensible, that will be enough for practical purposes.

This practical attitude seems to leave one question unanswered. Why should a corporation have a tax ethic at all? We have found ways to justify the contents of tax ethics, but that does not answer this fundamental challenge. There is, however, one thing we can say. If there were no business ethics, the environment would not be one in which business could flourish. And it would be quite difficult to argue that business ethics should not extend to taxation.

How should directors decide on standards?

In any large corporation, it is the directors who will have to set the tax ethic. They could make it demanding, or relaxed. How are they to decide?

They cannot take a vote among the shareholders. There will be too many of them, their views will be too diverse, and some major shareholders, such as mutual funds, will act on behalf of thousands of individuals. The directors also cannot rely entirely upon their personal values. As directors, their job is to serve the corporation, not to make the corporation behave exactly as they would behave in their private lives.

One obvious starting point is the views of the business community. There are plenty of business people who disapprove of aggressive tax avoidance, so a decision to listen to the views of business people is not a clever tactic to justify a relaxed ethic. Business people also have the advantage that they understand the pressures on businesses. They know that paying suppliers and salaries, and making a profit, have to come before paying tax.

Beyond the business community, it is sensible to consider the views of politicians, and of the well-informed public. This is partly because a tax ethic needs to be one that can help to justify the corporation's conduct to the wider world, and partly because people outside the business world can offer fresh perspectives. It is, however, perfectly reasonable for directors to disregard views that reflect ignorance of how tax systems work, or that are expressed merely in order to jump on a political bandwagon.

Having considered a wide range of views, directors must make their own decisions. They would fail in their responsibilities if they simply took some sort of average of the views they considered, rather than choosing a tax ethic themselves.

A tax ethic for the professional adviser

We have so far discussed ethics for taxpaying corporations. Can we extend the notion of a tax ethic to professional advisers, in a way that would take us beyond the standard professional ethic of reporting anything illegal to the authorities?

It is possible to do so, but there is an important constraint. The adviser's role is to present options to the taxpaying corporation. The corporation itself must take the decisions. It is not the adviser's job to **tell** the corporation

which options it should choose. It is also not the adviser's job to hide certain options from the corporation, because the adviser believes that those options would be ethically questionable.

Having said that, any adviser is free to say at the outset that they will not offer certain types of advice. An adviser can also cease to act for a client if they become unhappy with the choices that the client makes. We need a tax ethic that can give guidance on what limits to set on the conduct of clients.

One way to do this would be to say that an adviser should not act for a client unless the client's own actions were in accordance with a tax ethic that could be defended as reasonable. In this way, we can avoid the difficulty that would come from writing an ethic for advisers as if the tax affairs of their clients were their own affairs. Writing an ethic in that way would confuse the roles of advisers and decision makers. We avoid the difficulty by taking the tax ethics of corporations for granted, and then asking whether those ethics could be defended. An adviser could decide not to work for a client, if the client's actions did not comply with a defensible tax ethic. (Clients would not need to have written out their tax ethics. Advisers could still consider whether the actions of clients were in line with hypothetical ethics that would be defensible.)

This would mean that an adviser would not be tied to a single ethic that they expected their clients to observe. A fairly wide range of tax ethics might be defensible. But the adviser's position would be no worse than the position of any outside commentator on the tax ethics of corporations. We all need to recognise that there are several different answers to the question, "what should a tax ethic say?"

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