# European Union's Struggle with Tax Havens and Profit Drain

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ABSTRACT: The issue of corporate taxation applied in the jurisdiction in which a company operates has recently received increasing political traction, as tax havens have increasingly drawn attention and also as multinationals have developed colossal turnovers, far above the GDPs of less developed countries. Tax havens deprive of billions of dollars many states that have not established through adequate legislation an assertive fiscal control, generating and fueling social inequities and a high degree of poverty. By funneling money through tax havens to avoid the payment of taxes and fees, multinationals deprive national governments of large sums of money that could be directed to education or health programs.

KEYWORDS: tax havens, European Union, tax avoidance, profit shifting

## Introduction

In recent years, the European Union, taking advantage of the favorable context and political popularity of the subject, has outlined a series of measures and criteria to prevent the hiding of profits via tax havens and also to regulate "transfer pricing," i.e., transactions between companies in the same group, for which high commissions are charged in the country where taxes are lower, thus bringing a higher profit to the central level of a multinational.

A compelling example of this is EU Directive 1164/2016 – "AntiTax Avoidance Directive" (ATAD), which tries to combat cross-border tax avoidance practices and provide a common framework at the EU level for the implementation of OECD/G20 project results against the erosion of the domestic tax base and profit shifting (BEPS). The main measures proposed by ATAD are: Limiting interest deductibility; Enforcing an exit tax in case of transfers of assets/transfer of fiscal residence/activity of a permanent headquarter; General anti-abuse rule; Rules on controlled foreign companies (CFCs); Rules for combating the non-uniform treatment of hybrid financial instruments or entities.

One year later, the Union proposed Directive 2017/952 known as ATAD II, which provides for additional measures to combat the non-uniform treatment of hybrid financial instruments or entities. The new rules have as main goal the prevention of artificial transfers of profits through the possibility of contracting interest-bearing loans. Another aim is for companies belonging to a group to finance themselves more expensively both from their affiliates, respectively from other companies in the group, as well as from financial institutions, precisely to prevent this from happening in an uneven and unregulated setting.

The deadlines for implementing the transposition were January 1, 2020, for most of the provisions, with some of them having the possibility of transposition until 2023 - under certain conditions imposed by the specifics of national legislation. At the same time, the European Union has been working on a blacklist of tax havens operating outside the EU, even considering sanctions against these states. The list contains 17 jurisdictions and a gray list of 47 supervised territories that have agreed to make changes to national tax regulations. The first 17 states included in the list are: American Samoa, Bahrain, Barbados, Grenada, Guam, North Korea, Macao, Marshall Islands, Mongolia, Namibia,

Palau, Panama, Saint Lucia, Samoa, Trinidad and Tobago, Tunisia, and the United Arab Emirates.

## The need for rebalancing the taxation system in the European Union

The main purpose was to harmonize the tax legislation of so-called tax havens with relevant legislation at the Community level. However, it is extremely likely that European decision-makers have skipped some names from the list. There is also the happy case in which some states have complied with stricter rules in trade with the Community bloc and have thus left this list. It must be said that this list is constantly being updated and that European states find it quite difficult to agree on it.

The former European Commission portrayed the list as a real success. In a press release in March 2019, the European Commission announced that it assessed 92 countries based on three criteria:

1. fiscal transparency
2. good governance
3. real economic activity
4. existence of zero income tax rate indicator.

According to the situation presented by the Commission, 60 states have taken action in response to concerns expressed by the European executive, and more than 100 harmful tax regimes have been eliminated, thus the list has helped to universalize and standardize international tax practices. Two years after the list was introduced, the Union added 6 more states (Aruba, Belize, Bermuda, Fiji, Oman, Vanuatu, and Dominica) and announced that three G20 countries (Russia, Mexico, and Argentina) would be subject to scrutiny, due to a more in-depth examination and the introduction of more mandatory transparency criteria.

Overall, we can certainly say that the list is neither robust nor comprehensive. It could be improved if some objective criteria were applied and the main reason why these states would be put on such a list would not be a political one. There are also the EU Member States whose legislation is similar to some of those on the "blacklist of tax havens." This shows that although the Union's action is a step in the right direction, the criteria are not perfect and cannot include all tax havens. An objective blacklist with more clearly defined criteria, combined with measures to counteract the specific effects of the tax havens, and could ultimately lead to the end of tax havens.

Let us first consider the three criteria by which the European Union checks whether or not states are blacklisted and how they could be improved in order for the list to become objective. Tax transparency should mean that states are constantly exchanging information and good practices and are members of the Convention on Mutual Administrative Assistance in Tax Matters. The Convention is currently signed by 88 states.

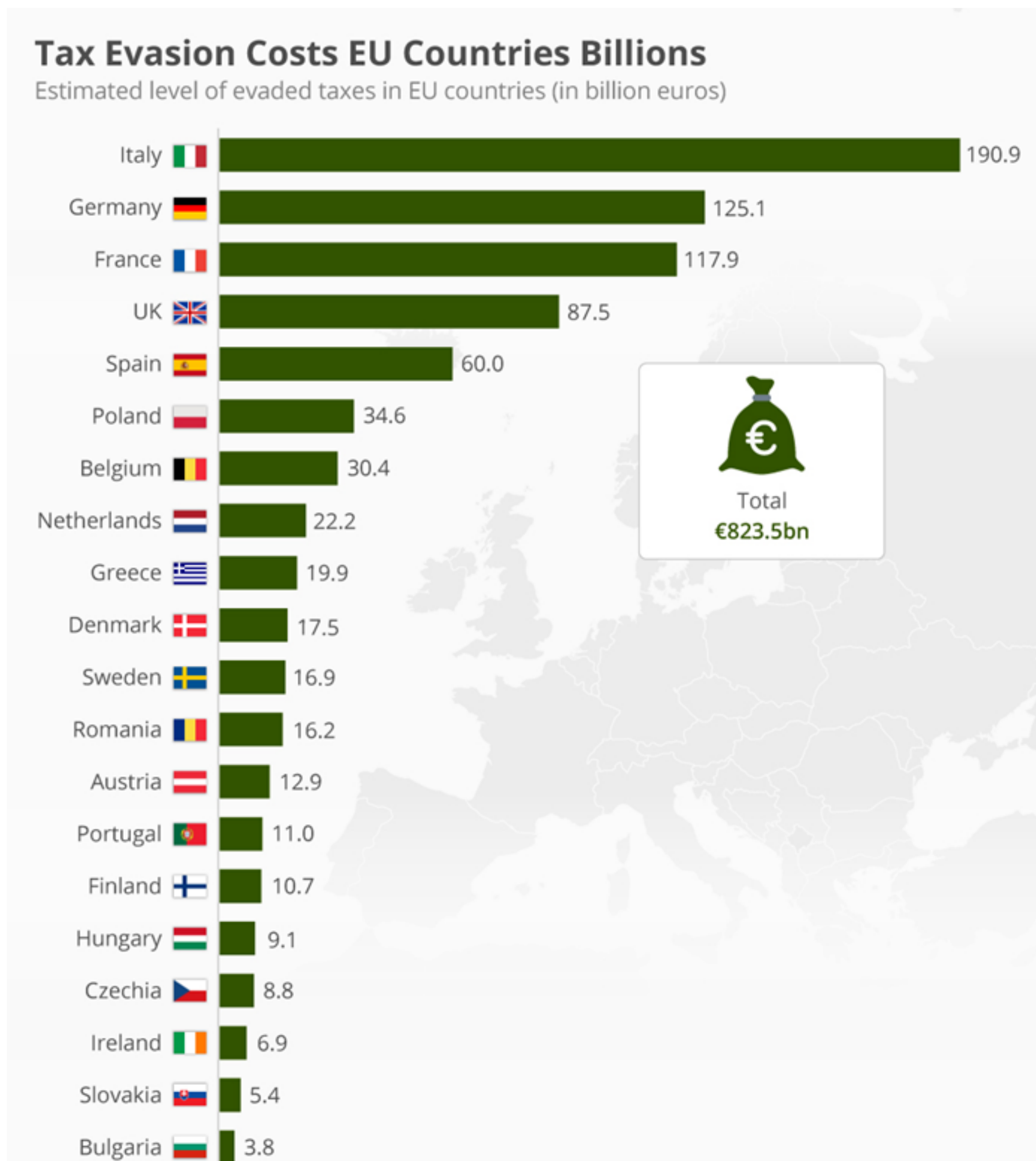


Figure 1. EU tax evasion costs
*Source: University of London Study, 2019*

Good fiscal governance would mean that states do not adopt preferential taxation measures, do not facilitate the use of offshore structures or other types of arrangements that drive profits that do not represent real economic activities. The existence of a zero tax rate is used as an indicator in this respect, but it must be said that the Union does not publicly offer the methodology on which it carries out these assessments. Therefore, we need to look in detail at other economic indicators through which some states can offer fiscal and tax advantages without any concrete economic activity.

The third equally important criterion should be the implementation of anti-BEPS measures. BEPS is an acronym that highlights the erosion of the tax base and the shifting of profits, being an OECD project that has generated a set of global standards against the "transfers of profits." OECD anti-BEPS standards are the basis of the ATAD Directive. In order not to be suspected of being a "tax haven," states must apply or comply with basic anti-BEPS standards.

Economists say that if these objective criteria were applied, at least 35 states would be blacklisted. Important names for the EU would be Albania, Northern Macedonia, Montenegro, Switzerland, or Serbia. The same analysts say that given a rigorous analysis, the Netherlands, Luxembourg, Ireland, and Cyprus should also be included in this list, having some of the worst corporate tax regimes. The scandals involving companies such as Apple or Amazon that avoided taxes by moving their headquarters to Ireland or Luxembourg are further proof that there are tax havens among EU member states as well. This fact has led to discussions at the European level on a so-called "GAFA tax (Google, Amazon, Facebook, Apple)," strongly supported by France.

The European Union must find the right mix between its regional development policy and the help it offers to developing countries with the legislative and regulatory coverage of European tax havens or those on the periphery of the EU. They deprive the Union budget of some revenue that could be used for education and health policies in poor regions.

Europe is also the region with the lowest average corporate tax rate in the world. Last but not least, the Union must treat its members the same as countries on the blacklist of tax havens, in the light of promoting fair and uniform taxation globally. The same regime must apply to the overseas territories of the Member States, which is currently an important issue in the Brexit negotiations.

For a blacklist of tax havens to be objective and effective, it must be free from any political interference or bias. All states must be assessed objectively, regardless of size or geopolitical power, otherwise, multinationals will turn to tax havens such as Singapore, an example of a state too strong to be put on such a list. There is also a need for more transparency in addressing this assessment. However, the European Commission's body in charge of the list is one of the most non-transparent institutions, hiding behind the confidentiality of data. Greater transparency and some public debate on this matter are needed to generate greater market confidence in this process.

**What levers does the European Union have at its disposal?**

As it has promised at the political level, it may be time for the Union to take concrete action to hold multinationals accountable, as well as some European countries, to stop the funneling of resources away from the development of societies. Tax havens are the result of an inefficient and malfunctioning global tax system. To enforce policies that combat social inequity at a global scale, large corporations need to actually pay their share of taxes, to ensure a socio-economic footprint in the states where they do business.

An effective first step in this direction is for the Union to adopt and then cascade to the Member States a blacklist of tax havens that is extremely clear and unequivocal. For this to be feasible the list must be drawn up based on some objective criteria and, most importantly, it must be free from any possibility of political intervention. Furthermore, the criteria on which the list is based needs to be constantly checked and improved so that they also apply to EU Member States where appropriate.

Transparency is another important element in the fight against tax havens. At the moment, it is not very clear what methodology the Union has adopted in trying to develop such a blacklist. European decision-makers must make available to the public the clear methodology and criteria on which they analyze tax havens. Furthermore, the Union may adopt corporate governance policies such as codes of conduct, which are binding for the fiscal policies of all Member States. This increased transparency would bring even more confidence among citizens, as well as fewer opportunities for political interference.

It is very important that these measures are doubled and coordinated by an active and determined position against the states on this blacklist. At the same time, the Union may take

defensive measures against the actions of these States, in order to limit the erosion of the corporate tax base in the country where the multinational operates, as well as the tactics aiming to move the profit away from the country of origin.
Governments need to act quickly to strengthen the so-called CFC rules, adjusting the laws to allow the taxation of profits sent to tax havens. Once improved, the rules will help limit artificial tax deferral by using low-tax offshore entities.

European tax havens must also be taken seriously and receive no special status compared to other tax havens. The Union may require its Member States to adopt a more restrictive legislative framework to help prevent misleading taxation practices. The legislative framework can also be extrapolated to create basic legislation on tax avoidance for payments such as royalties or interest.

Last but not least, the harmonization of legislative frameworks at the European level must be done in the light of the proposals present in the Common Corporate Tax Base (CCTB) and Common Consolidated Corporate Tax Base (CCCTB) Directives. Thus, they must be included in the harmonized system and when determining the basis of application for the corporate tax and the potential reputed gain from the digital activities of large companies. The rules on fiscal consolidation at the Union level, as well as the formula for allocating the tax base of a multinational among Member States, must be implemented as matters of priority. Member State governments have a duty to monitor the implementation and take punitive action if large corporations circumvent these rules.

These measures must complement those that help states break out of the paradigm of tax havens. Specifically, the Union can come up with economic and fiscal stimulus measures, which should go to the states that currently live from their status as tax havens, being dependent on the money that multinationals pump into the local economy. These measures can also be taken in a controlled way by the Member States, providing tax facilities to multinationals that choose to invest transparently in the development of facilities in states considered tax havens. The authorities have a duty to ensure that the socio-economic impact of the investment contributes to the economic development of the community. Such measures also develop a more stable, equitable, sustainable, and diversified economic framework globally.

## Conclusions

Tax havens and race-to-the-bottom policies help increase the profits of multinational companies, but at the same time deprive national governments of some revenue that could be directed towards social policies. The European Union has made a healthy and necessary exercise in identifying tax havens and blacklisting them. The Union will also outline a policy that will aim to convince as many states as possible to comply with some international standards and be removed from the blacklist.

However, the exercise has some shortcomings and political pressure has hampered the objectivity of the Union's decisions in this regard. For example, London's political lobby has long led to the EU turning a blind eye to Britain's Overseas Territories and Crown Dependencies. The British government has exerted its influence to exclude them from the list, but at the same time, it has done a lot to improve the transparency of economic activity in these territories. This has led London to adopt a focus on transparency in its discourse and not to include other criteria or aspects of taxation policies in the process of blacklisting territories. Practice has shown that many of these territories or dependencies have been at the center of scandals, being categorized as genuine tax havens. The British Virgin Islands are home to many companies that were discovered in the Panama Papers scandal. Bermuda is another example of this. Many of these territories do not levy a profit tax, placing them at the top of race-to-the-bottom policies.

The steps identified so far in countering tax havens show that the EU is on the right track, but there is still much to be done until the system becomes truly efficient. First of all, a set of rules must be outlined that does not succumb to the force exerted by politics and stands out as a result of objective and extremely clear criteria. The Union will also no longer be able to ignore indefinitely its Member States, which should be on this list given a rigorous approach. The measures must be applied in a very strict way by the authorities, and the blacklist must be combined with strong countermeasures that would lead states to avoid association with such an entourage.

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