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ILLEGAL STATE AID IN TAXATION AND POSSIBLE CONSEQUENCES FOR THE CROATIAN TAX ADMINISTRATION[1]

This article presents recent EU investigations on transfer pricing arrangements in corporate taxation of some multinational corporations. These investigations examine whether decisions by tax authorities in Ireland, The Netherlands and Luxembourg (regarding Apple, Starbucks and Fiat Finance and Trade, respectively) comply with EU rules on state aid. Encouraged by the efforts of the OECD and public criticism on the unfair allocation of the tax burden among multinational corporations and smaller, domestic businesses and ordinary people, the EU Commission has taken many measures in the last two years to make corporate taxes fairer across Europe. This article discusses the impact of current international efforts to re-arrange the global tax system on the Croatian Tax Administration which is trying to keep on the track of harmonisation with EU tax legislation, best practice and a partner-like relationship with taxpayers.

Key words: *fiscal state aid; EU investigations; Croatian Tax Administration.*

1. INTRODUCTION

Tax principles were developed at a time when economies were relatively closed and predominantly concerned with the domestic activities of individuals and enterprises. An international tax regime has been built around a network of bilateral tax treaties, the majority of which were

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structured upon the OECD Model[2]. Today, the international tax community (represented by the OECD, the G20 and the EU[3]) have recognised the need to harmonize tax systems and make them more transparent, with the final goal to tackle tax evasion at a global level.

According to the Commission, corporate taxation in the EU needs to be fundamentally reformed as the current corporate taxation rules within the EU no longer fit contemporary market realities[4].

The OECD and the EU, with the substantial monitoring of media, emphasise that the tax burden of the economic crisis is unjustly borne by smaller domestic enterprises and citizens, while multinational corporations use its opportunities to engage in tax avoidance. Such a generalisation and simplification of reality can hardly be explained by the risks and complexity of the environment that multinationals are confronted with.

Multinationals are facing a variety of financial markets, currency risks, costs and standards (of production models, environmental protection, accounting), tax and foreign exchange systems, as well as trade, cultural and sociological obstacles. All these different aspects of business are the result of different factors that affect them, due to the exposure of a group of companies in international markets. Differences in tax systems can result in double taxation and double non-taxation for multinational corporations (in spite of the general opinion that multinationals are constantly avoiding double taxation by taking every opportunity for double non-taxation). Actually, multinational corporations suffer from tax costs caused by disparities in international taxation unknown to small and medium enterprises nor to the majority of citizens. These costs include, for example, non-creditable withholding taxes, non-deductible items, transfer pricing disputes, unused losses and multiplied tax compliance costs[5]. For example, with increased internationalisation, "(M)ultinationals have been forced to hire an army of

[2] The OECD Model Tax Convention on Income and on Capital. The first OECD Model dates back to the time of the League of Nations, which initiated working on double taxation in 1920 and which eventually, in 1928, resulted in a first draft (*Bogovac*, 2014).

[3] Nearly 90 countries, members of the OECD, G20 and developing countries, are working together on the development of a multilateral instrument capable of incorporating the tax treaty-related BEPS (Base erosion and profit shifting) measures into the existing network of bilateral treaties (*OECD* 2013).

[4] *EU* 2015c, 11.

[5] *Bogovac* 2014, 12.

tax lawyers, accountants, and economists to defend the particular transfer prices they use"[6]. Today, 20 years after these words were written, multinational corporations are even more under pressure to protect themselves from ongoing public criticism and the scrutiny of the OECD and the EU regarding transfer pricing arrangements.

Simultaneously, during the last 20 years, in the course of the implementation of the modern tax system within the newly established market economy in Croatia, the tax administration has been on the path of harmonisation with the best practices of the EU in the area of legislation, efficiency and institutional reputation. Substantial efforts have been put into building a better relationship and better communication with taxpayers. The tax system has been used in order to make some activities or regions attractive for investors and to promote economic growth. All these activities were done to create a positive tax environment for business and thus motivate foreign direct investment.

With the aim of explaining all relevant aspects of the issue, in Part 2 of this essay the Croatian Tax Administration is presented. Part 3 offers explanations on EU investigations and several issues closely connected with them, namely the raising of public opinion and international efforts to combat global tax avoidance, the dynamic environment and profit-oriented management of MNEs, together with the rationales of transfer pricing regimes and the basics of fiscal state legislation. Part 4 predicts some possible consequences of the behaviour and practice of the Croatian Tax Administration and offers a conclusion to the issue.

2. TAX ADMINISTRATION IN CROATIA

The Croatian Tax Administration (hereinafter CTA) is the administrative organization within the Ministry of Finance whose basic task is to prepare, draft and implement regulations concerning the payment of taxes and obligatory contributions. The main duties of the CTA include: (i) normative activities; (ii) a proactive role in tax policy - to suggest changes in tax policy in order to improve the tax system and to collect, more efficiently, taxes and compulsory insurance contributions; (iii) numerous administrative and other

[6] *Tanzi* 1995, 139.

professional tasks within the process of the implementation of tax regulations and compulsory insurance contributions, including audits and simultaneous audits with representatives of competent authorities from Member States; (iv) international cooperation and administrative assistance with Member States and international organizations in the field of taxation; (v) the development and maintenance of a taxpayers service system to facilitate the fulfillment of the rights and obligations of taxpayers; (vi) tasks related to recording, determining, monitoring, collecting and enforcing the collection of taxes which belong entirely to the local and regional government and other public levies stipulated by law; and (vii) the collection and distraint of state budget revenues determined by the organizational units of the Ministry of Finance, upon the request of other Member States, and Croatian administration bodies and courts in accordance with special laws.[7]

Within the scope of normative activities, the CTA provides official opinions and interpretations in individual cases on the implementation of regulations. As of the 25 July 2015, in accordance with the General Tax Act and By-law on binding opinions, tax return correction, statistical reports and tax settlements,[8] a binding opinion may be issued on the following tax issues: (i) identification of taxable supplies for the purpose of pro-rata VAT calculation; (ii) application of the tax regulations on investment projects in Croatia whose value exceeds HRK 20,000,000 (approx. 2.6m EUR); (iii) tax base assessments in business combinations (excluding those in accordance with the relevant EU directives; and (iv) the application of double taxation treaties to the assessment of corporate and personal income tax liabilities. Additionally, a binding opinion may be issued on a tax issue with regards to business activities that are, due to their specific particularities, not typical in the Croatian business environment. The binding opinion is subject to a fee. The fee must be paid by the applicant before the submission of the application and its structure depends on the revenue the applicant has

[7] As prescribed by the *Decree on internal organization of the Ministry of Finance* the CTA performs multifold duties listed separately, as well as other duties stipulated by the *Tax Administration Act.* For the purpose of simplification and a general view of the roles and responsibilities of the CTA, they are all arranged here in seven groups of tasks.

[8] Art. 9.a of the *General Tax Act* and Art. 1. – 13. of *the Bylaw on binding opinions, tax return correction, statistical reports and tax settlements*.

declared in its tax return (max. HRK 30,000 or approx. 4,000 EUR). The CTA is obliged to issue the opinion within 60 days of the application date, however the deadline may be extended by 30 days in particularly complex cases. To the best of the author's knowledge, the CTA has not issued any binding opinions until now, but some are under preparation.

Tax administration in Croatia, like in other countries from Central and Eastern Europe, does not have long a history, tradition or experience in a market economy or the globalized world. Moreover, at the very beginning of its establishment, the CTA suffered from substantial pressure to collect public revenue during the Homeland War (1991-1995). After a long and scrutinized screening and audit of the harmonization of the tax legislation with the *acquis communautaire*, on 1st July 2013 Croatia became the 28th member of the European Union. While the other EU countries already felt the benefits of the recoveries of their economies, Croatia has been facing a period of austerity, with the CTA being under even more pressure to maintain public finance. If we bear in mind the dual (and self-contradictory) responsibility of tax administration, i.e. to collect public revenues in accordance with the budget and to promote the investment climate in the country by supporting it with different tax incentives that will decrease tax payments in the short-run, it goes without saying that the latter is of less importance for the CTA..

Frequent changes of tax legislation and the organisation of the CTA during the last two decades, repeatedly caused by political changes in Government, together with a weakly equipped tax administration, have created additional tensions between taxpayers and the tax administration.

During the process of accession to the EU, the Commission's progress reports in the area of taxation (Chapter 16)[9] were not very optimistic about the improvements in the Croatian tax system, but the most important issue that needed to be resolved remained administrative capacity.[10] This is the rational conclusion, because although the overall structure of the tax legislation was similar to the *acquis*, the alignment of Croatian tax

[9] Since March 2002, the Commission has reported regularly to the Council and the Parliament on progress made by the countries of the Western Balkans region.

[10] Even in the years with better reviews, for example for 2010, when the Commission found that "Croatia made good progress" in some area of taxation, administrative capacity remains emphasized as improvable (*cf*: *EU* 2007, 40-41; *EU* 2010, 41).

legislation persists in being "far from complete" and "further alignment is required".[11]

Legal tax certainty was substantially improved with the General Tax Act enacted in 2000. However, the non-uniform and authoritarian practices of the tax administration needed to change from the traditional old-fashioned relationship with the taxpayers to a modern, proactive partnership-like cooperation based on trust. The experience of the tax administrations of Member States was used as a guideline for the implementation of principles laid down in the law. The general goal of the CTA's external communication has become "(T)o build the reputation of the CTA as a successful institution of Croatia's public sector based on good communication with the taxpayers"[12]. This goal should be reached by improvements in communication services, transparency in communication, training and knowledge-sharing. Changing the course of work from the single control and collection of taxes to more sophisticated ways of fulfilling its roles and responsibilities (in, basically, reaching the same goals) implies a change from the routine type of organisation technology[13] to an organisation that provides extraordinary public services. In the constantly and fast changing business environment, it is crucial to understand taxpayers[14] and *vice versa*, hence communication and good faith is key.

The CTA issued a *Charter of cooperation with taxpayers* in June 2014, aiming to improve understanding of the rights and obligation of taxpayers.[15] The simple, transparent and concise wording and structure of the Charter, together with the limited number of pages (nine pages in total), clearly

[11] Ibidem

[12] *CTA* 2012, 5.

[13] *Koprić* 1999, 416.

[14] For example, the tax administration officials can found themselves in the unenviable position of providing interpretations, omitting or failing to prevent transactions that exceed their capabilities. Tax administrations do not have much knowledge of the business conditions under which taxpayers make business decisions on a daily basis, specific to each industry and by the undertaking. Also, officials have no support in its organizational unit as employees working on joint projects at entrepreneurs have it. Therefore, the tax inspectors often are in the unenviable position where it is easier to reach for the "safer" choice, that is to decide at the expense of the taxpayer (*Bogovac* 2014, 99-100).

[15] *CTA* 2014.

explain what taxpayers can expect from the CTA and what the CTA expects from them.

In addition to other instruments that are embedded in the General Tax Act (*supra* mentioned binding opinion and tax settlement), the issuance of *The Communication Strategy*[16] and Charter (2014), *The Code of professional ethics of public servants in Tax Administration,*[17] *Strategy of the Tax Administration*[18], as well as numerous workshops and the training of CTA employees, have been accomplished in the last 20 years. Even though all these efforts mean less, being only words on paper, if not supported with a change in the state of mind and a devotion to persist in the implementation of an enhanced relationship with taxpayers, they still form a solid basis for a new era in the relationship between the CTA and taxpayers in Croatia.

3. EU INVESTIGATIONS OF FISCAL STATE AIDS

The OECD sets new international standards and creates the basis for an EU approach in tackling double non-taxation of multinational enterprises. With a view to improving the functioning of the internal market and protecting tax revenues, the European Union recognized aggressive tax planning as a global issue that needs to be solved along with the OECD and Member States.

Fiscal state aid rules have been applied in the European Union for decades, but their application in the context of tax rulings is relatively new. Tax rulings have been issued by tax authorities as a response to taxpayer's questions and create certainty for taxpayers and tax authorities. Though completely legal and desirable, they may involve state aid and be subject to scrutiny from the European Commission. In the last few years the Commission has tightened its control of fiscal state aid, by using the EU competition tools, in order to examine individual tax rulings issued by Member States to apply to some multinational corporations. These rulings were concluded as advance pricing agreements with taxpayers in order to determine transfer prices used by taxpayers in future transactions in the

[16] *CTA* 2012.
[17] *CTA* 2009.
[18] *CTA* 2011.

complex and unpredictable business environment. Transfer prices are the most complicated issue in the field of taxation, and also constitute a very useful instrument for tax avoidance by multinational companies, as well as for tax revenue for governments. Therefore it is unsurprising that the European Commission has started to establish a systematic approach to the problem of tax rulings within the available measures of state aid.

3.1. Public opinion and international efforts

Multinational corporations are often blamed for undermining social welfare. Awakened public attention that questions "good corporate citizens" has resulted in movements towards the establishment of codes, guidelines, communications, notes and declarations in the international regulation arena. Substantial improvements regarding corporate governance and the tax responsibility of MNEs have been made in the last decade due to the escalated activities of media and politicians.

Though public opinion can be defined (slightly ironically) as "opinions held by private persons which governments find it prudent to heed"[19], many fiscal programmes and political initiatives have been announced with the aim of closing loopholes which allow large corporations to avoid paying the proper amount of taxes in the countries where they make their profits. Necessarily, these actions have been rationalized by the need for fairness in taxation.

In the 1990s, the incoming American Democratic President, Bill Clinton, announced his "determination to step up control over taxation of foreign MNEs on the premise that foreign corporations do not pay their 'fair share' of taxes in the United States"[20].[21]

Following a proposal from a report issued in 1998 (*Harmful Tax Competition: An Emerging Global Issue*; *OECD* 1998, 9), the OECD has created a special forum named *Forum on Harmful Tax Practices,* whose work focuses on three areas: (i) harmful tax practices in Member Countries; (ii) tax havens; and (iii) involving non-OECD economies. The Forum has

[19] As defined by the American political scientist V.O. Key in 1961 (*Britannica* 2015).
[20] *Wallace* 2002, 898.
[21] Though the later Report by the Internal Revenue Service showed that "for the most part, foreign companies do pay their fair share of taxes"(*Wallace* 2002, 898).

also issued a *Model Tax Agreement on Exchange of Information in Tax Matters*.

In 2004, the EU Commission adopted a *Communication on Preventing and Combating Financial and Corporate Malpractice*, which provides a strategy for coordinated action in financial services, company law, accounting, tax, supervision and enforcement areas, in order to reduce the risk of financial malpractice[22]. In the area of taxation, the Commission suggests more transparency and information exchange in corporation tax in order to enable tax systems to better deal with complex corporate structures.

In April 2009, the Commission adopted a Communication identifying actions that EU Member States should take to promote "good governance" in the area of taxation (e.g. more transparency, exchange of information and fair tax competition). The Communication identifies how good governance could be improved within the EU. It also lists the tools that the EU and its Member States have at their disposal to ensure that good governance principles are applied at the international level. Finally, it calls on Member States to adopt an approach that is more coherent with good governance principles in their bilateral relations with third countries.

Driven by a context of tight public budgets and financial crisis in the years following 2008, the OECD and the EU continued with efforts to combat tax avoidance by big business. Even though some developed countries conducted their own investigations in 2012 (namely USA[23], France[24] and UK[25]), substantial improvements were accomplished by EU investigations in the domain of fiscal state aid.

Google is an example of a multinational company that has been exposed to public criticism and the scrutiny of tax administrations and committees in the UK and France, due to the minimized tax paid within the letter of the law. After public accusations claiming that Google used complicated legal structures to avoid tax obligations in the UK (*Wintour and Arthur* 2013), six years of Google's UK tax returns (2006-2011) were placed under review by

[22] *EU* 2004b.

[23] Senat investigations on Microsoft, Hewlett-Packard and Caterpillar (*USA* 2012; *USA* 2012a).

[24] France investigated Apple, Google and Facebook Inc. (*Fairless* and *Schechner* 2014).

[25] The Parliament Committee on Public Accounts held a hearing with representatives from Amazon, Google and Starbucks (*UK* 2012b).

HMRC. This increased legal tax uncertainty for Google and other corporations. Interestingly enough, HMRC was also accused by the Parliamentary Public Accounts Committee of ineffectiveness in enforcing the tax laws and collecting tax "owing under both national and international tax systems"[26].

Maybe the reason why HMRC is "lenient with big business"[27] can be linked to the collaboration of Google with the British Government regarding the new Google Campus in London. In addition to cooperation with academics and business, the British Government has also cut tax rates and introduced new tax incentives aiming to "create new jobs, new growth and new prosperity" in the UK, and "build a more competitive economy".[28] Though Google reported a low effective tax rate in the UK, it has to be taken into consideration that it clearly disclosed its minimized UK tax and explained that this had been effected in accordance with tax legislation. Confronted with a dynamic environment, especially in the global arena, investors and analysts expect management to earn profits and, at the same time, to play fairly, acting as a good corporate citizens. A similar dual responsibility for HMRC is also self-contradictory: "it had been a policy of successive Governments to make the UK an attractive place for business and for multinationals to see the UK as competitive"[29] while pursuing all the tax due from multinationals in accordance with tax laws.

Cooperation with the government, and active roles in the creation of a competitive economy in the UK, and paying taxes in accordance with the letter of law, did not bring public approval to Google (nor to the UK Government); rather it brought great risks of financial losses and legal tax uncertainty. Representatives from Google attended the hearing held by the UK Parliamentary Committee, pursuant to the Committee's intention to explore issues on artificial transactions which Google used to reduce their profits in the UK.[30] Though the Committee was not convinced on the business rationales offered by Google, it expressed its gratitude for the

[26] *UK* 2012b, para 2.
[27] *Ibidem.*
[28] *UK* 2012a.
[29] *UK* 2012b, para 2.
[30] *UK* 2012b, para 10-11.

provision of evidence, because this gave them an example of the practices of other multinationals.

All this time, Google was under constant media pressure for paying less tax in the USA and the UK then the majority of local companies and citizens. Corporate reputation is a very important aspect of the business future, because the ethical behaviour of corporations is an "important issue to their customers"[31]. Thanks to public opinion, a newly enacted UK tax is popularly called the 'Google tax'.[32] While other countries also raised questions about Google's tax avoidance schemes,[33] and Ireland changed its tax legislation in order to close tax loopholes used by Google, [34] the company has become famous not only for its innovations but also for its tax affairs.

Google's representatives have been very collaborative with respect to participation at hearings, investigation and public debate. This shows that they were either (i) convinced of the certainty of the company's tax planning schemes, due to the respect they showed to legislation, or (ii) aware of the importance of public opinion. Almost certainly, they were both: maybe, at the beginning, they were sure that they had arranged their tax affairs in the most reasonable and legally safe way, because they would not have used such tax planning techniques if they had been aware of the possibility of such a public response. Later, awareness of damage caused to its corporate reputation prevailed, so the possible penalties for the previously used techniques were overridden by the possible financial losses that might be caused by the loss of trust of their customers. It seems that neither Google's management nor its tax advisors where alerted to the change in the global tax playing field.

[31] *UK* 2012c, para 12.

[32] Diverted Profits Tax, introduced in Finance Act 2015, applicable from April 2015. Tax is implemented to UK legislation in aim to counter the use of aggressive tax planning techniques used by multinational enterprises to divert profits from the UK". The standard rate of DPT is 25% of the diverted profit plus any 'true-up interest' (*UK Government* 2014).

[33] For example in Italy, see: *D'Alessandro and Masoni* (2015).

[34] *Stamp* 2014.

As Google chairman Eric Schmidt told political leaders: "if there was a distinction between the letter and the spirit of the law, companies expect politicians to define the difference".[35]

Still, it is understandable that "there is genuine public anger and frustration" due to a notion that "rigorous action is taken against ordinary people and small businesses" in contrast to the benevolent approach to large, especially foreign-based corporations.[36]

The OECD has continued its work on the integrity and fairness of tax systems. In July 2013 it published its Action Plan on base erosion and profit shifting (hereinafter BEPS) in order to address perceived flaws in international tax rules. BEPS contains 15 separate action points or work streams on different tax planning strategies that "exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid"[37]. G20 countries also participated in the development of BEPS, while the EU has, already in March 2013, emphasized the importance of fiscal consolidation to ensure that everybody pays their share of taxes. It concluded that "(C)lose cooperation with the OECD and the G20 is needed to develop internationally agreed standards for the prevention of base erosion and profit shifting".[38]

Tax evasion has been an important topic in most of the G8 countries[39] and it is unsurprising that, during the G8 meeting in June 2013, the UK Prime Minister David Cameron concluded that they "will focus on 3 Ts: Taxes, Transparency and Trade" (the transparency mentioned here functions to improve fairness in taxation).

The OECD Report from 2014 (regarding Action Item 5 of the BEPS Action Plan) points out a different approach to preferential regimes, less ring-fencing and more oriented to the reduction of the corporate tax base of some

[35] This requirement is concretely addressing Ed Miliband, the Labour leader who challenged Schmidt to say whether "Google would comply with the "spirit" of the tax laws, which might then lead to it being taxed more" (*Wintour and Arthur* 2013).

[36] *UK* 2012b, para 3.

[37] *OECD* 2013.

[38] *EU* 2013, para 6.

[39] As, for example, investigations on banking and offshore oasis (USA), football coaching star (Germany), fashion icons and former Prime Minister (Italy), football player (Spain, under pressure of G8) (*Phillips Erb* 2013).

multinational corporations which manipulate the base with particular types of income.[40]

On 17 June 2015, the Commission adopted an Action plan for fair and efficient corporate taxation in the EU. Corporate taxation in the EU, according to the Commission, needs to be fundamentally reformed. Therefore, the Action Plan sets out to reform the corporate tax framework in the EU, in order to tackle tax abuse, to ensure sustainable revenues and to support a better Single Market by encouraging the business environment. The Commission identified five key action areas: (i) re-launching the Common Consolidated Corporate Tax Base, CCCTB; (ii) ensuring fair taxation where profits are generated; (iii) creating a better business environment: (iv) increasing transparency; and (v) improving EU coordination.

The recent EU Commission Work Programme 2016, with the suggestive title 'No Time for Business as Usual'[41] committed to focusing "on the big things where citizens expect Europe to make a difference". Taxation, namely corporate taxation and fairness ("based on the principle that companies should pay taxes in the country where profits are generated"[42]), finds its place among several very important issues. The Corporate Tax Package consists of a set of measures to enhance the transparency of the corporate tax system and to fight tax avoidance, including the implementation of international standards on base erosion and profit shifting, and a staged approach starting with a mandatory tax base together with the withdrawal of the existing CCCTB proposal[43].

Simultaneously with the efforts of international and supranational organizations to fight against aggressive the tax planning of MNEs through guidelines, reports and action plans, formal investigations into EU fiscal state aid have been undertaken, explained *infra* in more detail.

After the widespread awareness of the importance and unfairness of the tax evasion of (some) multinationals during the last decades, the question remains as to why governments have not acted sooner after the aggressive tax planning of the multinationals came to light? A reasonable explanation

[40] *OECD* 2014.
[41] *EU* 2015.
[42] *EU* 2015c, para 8.
[43] *EU* 2015c.

is given by a "source close to Osborne", the UK chancellor in 2013: "introducing the changes earlier may have scared the companies away from the UK and the nation could have lost them as big employers". Now, however, the source has said "the tide of global political opinion has changed and the rest of the world agrees that tax avoidance must stop"[44]. If every government had been driven by the same fears, it is obvious that the outcome with regards to international taxation could not have been different. It seems that global tax issues need global actions to be solved at national levels. Unfortunately, global movements need more time, thus it took decades to reach this point of harmonization. Through the diligence and unity of the leading organizations and countries around the globe, we can expect to see a new global tax arena, accomplished with the new global economy.

3.2. Transfer prices, rulings and advance pricing arrangements

"Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises", and they are "significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions"[45]. There are many types of inter-company transactions, which include transfers of tangible and intangible property, and the provision of services and finance, as well as rentals and leasing arrangements. The basis for determining proper compensation is the arm's length principle. This principle requires that compensation for any inter-company transaction conform to the level that would have applied had the transaction taken place between unrelated parties, all other factors remaining the same. Even though the principle is simply stated, the actual determination of arm's length compensation is very complex.

The OECE Guidelines study various pricing methodologies, with examples of their application, the first being "traditional transaction methods". These are preferable methods as they are the most direct. However, under the

[44] *Neate* 2014.
[45] *OECD* 2010, 19.

Guidelines, a taxpayer must select the method that provides "the best estimation of an arm's length price".

In addition to "traditional transaction methods" (the comparable uncontrolled price method, the resale price method and the cost-plus method), the OECD Guidelines describe "transactional profit methods" (the transactional net margin method and the transactional profit split method) that can be used to establish whether the conditions imposed between associated enterprises are consistent with the arm's length principle.[46]

Another important issue regarding transfer pricing arrangements and EU investigations in the last two years are advance pricing arrangements (APAs) and tax rulings.

"An APA is an arrangement that determines, in advance of a controlled transaction, an appropriate set of criteria (e.g. method, comparable and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transaction over a fixed period of time"[47]. APAs can be unilateral, bilateral or multilateral (involving the taxpayer and one, two or more tax administrations). Administrative tax rulings are provided by many national tax authorities for reasons of legal certainty for taxpayers regarding specific transactions, for example in determining arm's length profits for transfer pricing transactions. In some countries advance rulings are published and some of them "have adopted circulars regulating the scope and extent of their ruling practices"[48].

The importance of administrative rulings in taxation and their relationship with state aid measures is highlighted in situations where, often in the absence of publication, they contain an interpretation of provisions which deviates from case law and administrative practice. The Commission indicates the importance of involved selectivity in tax rulings by bringing attention to particular circumstances: "(i) the tax authorities have discretion in granting administrative rulings; (ii) the rulings are not available to undertakings in a similar legal and factual situation; (iii) the administration appears to apply a more 'favourable' discretionary tax treatment compared with other taxpayers in a similar factual and legal situation; and (iv) the

[46] *OECD* 2010, 59.
[47] OECD 2010, 23.
[48] *EC* 2014b, 44.

ruling has been issued in contradiction to the applicable tax provisions and has resulted in a lower amount of tax."[49].

The aim of advance rulings should be to give taxpayers formal confirmation of related tax consequences in advance of entering into specific transactions. It should not result in the lower taxation of the taxpayer who obtains it, in comparison with taxpayers in a similar economic and legal situation who were not entitled to such rulings. The tax administrations of Member States should provide legal tax certainty and predictability but not selective state aids.

3.3. Fiscal State Aid – Legal Basis

In accordance with the EU policy of making the EU market equally competitive and fair for all companies, state aid rules (Articles 101-109 of the Treaty on the Functioning of the EU, hereinafter TFEU) prescribe conditions for undertakings and rules on competition, while Articles 110 to 113 of Chapter 2 (ex Articles 90 to 93 of the Treaty establishing the European Community, hereinafter TEC) separately lay down provisions on tax measures that may be regarded as fiscal state aid[50,51].

If the European Commission (Commission Directorates-General for Fisheries, Agriculture or Competition) has doubts about the compatibility of state law with the state aid provisions of the TFEU, for example, if a company receives government support as an advantage in any form on a selective basis, the Commission will open a formal investigation procedure. Where Member States prescribe general measures which do not address individual undertakings in a way that they do not depart from the general tax rules referring to all taxpayers in that country, the state aid provisions of the TFEU do not apply. On the contrary, if a tax measure is discriminatory, favouring specific enterprises or certain activities, it gives rise to proceedings for infringement under the rules of state aid prohibition.

State aid measures are characterized by the following: (i) they involve an intervention by the state or through state resources**;** (ii) they give the

[49] *EU* 2014b, 45.

[50] Together with Chapter 3: Approximation of Laws - Articles 114 – 117 (ex Articles 95 – 97 TEC) and Article 118, these articles make the Title VII of the TFEU – "Common rules on competition, taxation and approximation of laws".

[51] *EU* 2002.

recipient an advantage on a selective basis**;** (iii) they cause or may cause a distortion of competition; and (iv) they affect trade between the Member States.[52]

Tax provisions (Chapter 2, Title VII TFEU) prescribe tax measures in the form of state aid in the field of the turnover taxes, excise duties, repayments of exports and other forms of indirect taxation. Without prejudice to the reasons for the absence of similar provisions in the TFEU in the area of direct taxation, the Commission has made a considerable effort in tackling harmful tax competition and improving transparency in business taxation.[53]

In 1998 the Commission issued a *Notice on the application of state aid rules to measures relating to direct business taxation* (98/C 384/03, hereinafter the Notice[54]) where it refers to the aids granted by states (today Article 107, paragraph 1 TFEU) of Chapter 1 (Rules on competition) which states that:

> "*any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.*"

A tax measure constitutes aid if it meets the cumulative criteria:

1. It gives an advantage through a reduction in the firm's tax burden in various ways (a reduction in the tax base, a total or partial reduction in the amount of tax or deferment, cancellation or special rescheduling of tax debt).
2. The advantage is granted by the state or through state resources, including the forms of fiscal expenditures, granted also by regional or local bodies, through tax provisions of a legislative, regulatory or administrative nature, as well as through the practices of the tax authorities.

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[52] Art 107, para 1 TFEU.

[53] 1 December 1997 may be considered a starting date, when the Council (ECOFIN) adopted the Code of Conduct for business taxation, after a wide-ranging discussion on the need for coordinated action at Community level to tackle harmful tax competition, including state aid (Articles 92 to 94 TEC).

[54] *EU* 1998.

3. The measure affects competition and trade between Member States due to the exercise of an economic activity of the beneficiary (regardless of it's legal status or means of financing, or the fact that aid is relatively small in amount, or the fact that the recipient is moderate in size and regardless of the fact that the recipient does not carry exports inside the Community).
4. The measure favours certain undertakings or the production of certain goods, including selective advantages which derive from an exception to the tax provisions of a legislative, regulatory or administrative nature or from a discretionary practice of the tax authorities[55].

Even though the Commission was initially supposed to review the application of the Notice two years after its publication (Paragraph 38), the *Commission report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation* (hereinafter the Report) was adopted by the Commission on 9 February 2004[56]. Due to the shortage of tax aid cases before 2001, the Commission had decided to issue the Report when it had sufficient experience in the actions taken in the field of tax aid. The aim of the Report was to accomplish an initial review of how the Notice has been applied.[57] After an extended but concise analysis of transfer pricing methods and many state-specific regimes of diverse tax measures, which constitute different fiscal state aids, the conclusions consist of three aspects:

(i) the application of the Notice has allowed it's principles to be clarified while being a suitable tool for assessing tax aid;

(ii) with regards to the relationship between state aid monitoring and actions to tackle harmful taxation, the Commission will continue to review tax aid, focusing on aid with significant economic impacts and particularly harmful effects on trade and competition; and

[55] In some cases, the nature or general scheme of the tax system may constitute the justification of the selective nature of a measure: the distinction between state aid and general measures are explained in more detail in paragraphs 13 – 16. *See also EU* 2012.
[56] *EU* 2004a.
[57] The purpose of the Notice was (i) not to constitute a new set of guidelines for assessing tax aid nor to signal any change in the Commission's approach to assessing the compatibility of such aid, but to (ii) clarify how Articles 87 and 88 TEC (new Articles 107 and 108 TFEU) applied to tax measures (Report, para 3).

(iii) with regard to the question as to whether the principles set out in the Notice that concern only direct taxation can be applied to indirect tax measures, the Commission concluded that "the current Notice has provided a basis for the work in certain cases, in particular as regards the application of the principle whereby measures may be justified by the nature and general scheme of the system, but it does not cover all aspects of indirect taxation".[58]

3.4. EU Investigations

After the Reuters release of a special report titled *How Starbucks avoids UK Taxes* on 15 October 2012, which compared legal filings in the UK with Starbucks' own group reports and transcripts of conference calls with investors and analysts over a 12 year period, and showed huge differences between Starbucks' performance as disclosed to the government and as marketed to the public,[59] there was an immediate public and political reaction, including protests of activist organizations[60] and testimonies before a Committee held in November 2012.[61]

Even though some accusations failed to identify specific and concrete financial interests in Starbucks' favour,[62] the mere fact that the UK taxable base had been decreased formed a solid base for the further suspicion of the Committee and the public. Moreover, these transactions were also the subject of voluntary tax payments that Starbucks rendered in December 2012 "above what is currently required by tax law".[63]

But these moves, conducted with the aim of minimizing the impact of the public outcry and recovering the trust of customers, have not impressed officials in the Commission. Following a statement a Starbucks executive

[58] *EU* 2004a, para 75 – 80.

[59] The Committee found it "a bit odd" because the company were reporting losses in accounts submitted "to Companies House" and simultaneously "were promoting profits and promoting the individual responsible for the UK business". Additionally, an inconsistency was found in the fact that Starbucks in UK "have run the business for 15 years", with losses, but still are "carrying on investing here" (*UK* 2012c).

[60] *Huet* 2012.

[61] *UK* 2012b, para 7 and 8.

[62] For example, the loans that Starbucks UK received from the Starbucks headquarters in the USA, have not produced any tax savings at the consolidated level, due to the fact that the profits were moved to a country with a substantially higher tax rate (*UK* 2012c).

[63] Starbucks, 2012.

made to the Committee during the hearing, they "had a special tax arrangement with the Netherlands", which they were asked to "hold in confidence"[64], in July 2013 the Commission asked the Dutch authorities to provide information regarding tax ruling practices in the Netherlands and all rulings related to Starbucks' Dutch subsidiaries.[65]

The Commission opened an in-depth investigation into individual tax rulings and the tax regime in the Netherlands. Even though the Commission "does not expect to encounter systematic irregularities in tax rulings" in the Netherlands, it expressed concerns that the tax rulings for Starbucks Manufacturing EMEA BV (the Dutch subsidiary of Starbucks) "is providing that company with a selective advantage, because there are doubts about whether it is in line with a market-based assessment of transfer pricing".[66]

Based on a preliminary analysis of calculations used to determinate the taxable basis in this ruling, the Commission expressed concerns that they could decrease the taxable profits for Starbucks in the Netherlands, and thus could constitute state aid.[67]

A preliminary analysis presents the transfer pricing regime in general and the transfer pricing arrangements Starbucks had agreed with the tax authorities in the Netherlands.[68] It is a comprehensive report on all aspects of the legal and economic circumstances of the transactions between the Dutch subsidiaries and other related parties: financial reports, legal structures, APAs, benchmarking analysis, functional analysis and selection of transfer pricing methods; it consists of 132 recitals and a decision, in total 40 pages. It thoroughly explains and concludes on the substance of the analysis, examining in a very detailed manner the transfer pricing methods agreed by the Dutch tax authorities.

On 21 October 2015, the Commission issued a press release on the negative decisions with respect to the recovery from Starbucks and Fiat. The APAs concluded between these corporations and Member States constituted unlawful state aid[69].[70] Due to the artificial and complex methods endorsed in

[64] UK 2012c, para 8.
[65] *EU* 2014a.
[66] *EU* 2014.
[67] *Ibidem*.
[68] *EU* 2014c.
[69] *EU* 2015d.

the tax-rulings,[71] taxable profits were established in a way that they did not reflect economic reality. The concrete results for the Starbucks' coffee roasting company were profits shifted abroad, with the tax burden being unduly reduced by EUR 20 to 30 million over the period under investigation. The Commission required the Netherlands to recover such state aid from Starbucks, and the company must cease to benefit from the advantageous tax position granted by this ruling.

The Commission found that Starbucks used two ways to artificially lower taxes in the Netherlands, through Starbucks Manufacturing EMEA BV. This is a Starbucks manufacturing company based in the Netherlands as the only coffee roasting company in the Starbucks group in Europe which sells and distributes roasted coffee and coffee-related products (such as cups, pastries and packaged food) to Starbucks outlets in Europe, the Middle East and Africa. These two ways are:

i. A substantial royalty paid for the use of know-how. It cannot be justified, as it does not adequately reflect market value. Royalty payments to affiliated company Alki in the UK[72] for coffee-roasting know-how was the only know-how payment because no other Starbucks group company, or independent roasters to which roasting is outsourced, are required to pay a royalty in essentially the same situation. The existence and level of the royalty means that a large part of its taxable profits was unduly shifted, as the Commission found. Alki was neither liable to pay corporate tax in the UK, nor in the Netherlands. These overestimated royalties, as accepted by the

[70] At the time of the finalization of this article, the public version of decision was not yet available. As explained, it will be displayed as soon as it has been cleared of any confidential information. Therefore, with the aim of finding an adequate explanation of the arguments used by the Commission and the Netherlands, the EC Letter to the Netherlands is used in this article, even though later documentation and meetings were observed by the Commission (*EC Letter*, C(2014) 3626 final).

[71] It is emphasized again that tax rulings as such are "perfectly legal".

[72] Interestingly enough, during the Committee hearing in the UK, Alki LP, the UK based company that receives the royalty payments, was not mentioned. Even though the fact that royalties are remitted back to the US was stressed few times, this tax transparent legal entity (limited partnership with partners in the Netherland and in the USA), if mentioned in due course at the hearing, might raise the question of UK competence over this remuneration route.

Dutch tax authorities, conferred a selective advantage on Starbucks Manufacturing BV.

ii. An inflated price for green coffee beans to Switzerland-based Starbucks Coffee Trading SARL, that unduly reduced Starbucks Manufacturing tax base, leaving no margin to pay the above mentioned royalties (since transfer prices for its manufacturing/roasting services were set at very low level). This caused other profits of the Starbucks Manufacturing BV to cover royalty remunerations and decrease tax due in the Netherlands.

Both ways that Starbucks used, and the Dutch tax authorities approved, to artificially shift those profits where there was no economic justification, were analyzed by the Commission in detail in accordance with the OECD transfer pricing guidelines.

As for the first point, in relation to the royalty payments to Alki LP, the most important concern for the Commission was the volatility of the royalty payments from year to year, which was not in line with sales (or profits). Moreover, the artificial character of the APA was recognized in situations where the royalty payments were negative, which would not be the case in transactions between independent economic operators. Finally, the complex and separate calculation of the royalty payments for know-how in the roasting process, which is more technical specification than intangible innovation, together with previous arguments, suggested that the level of those remunerations could have been overestimated.[73]

The second way used to artificially decrease the tax base, payments for the raw materials at inflated prices, was in direct connection with: (i) the classification of Starbucks Manufacturing BV as a low-risk toll manufacturer; and (ii) two adjustments of the cost base for the application of the mark-up within the TNMM.

A toll manufacturer (or contract manufacturer) usually processes raw materials or semi-finished products for another company and, as opposed to a fully-fledged manufacturer, does not bear the risk of inventories (or owns the inventory). Toll manufacturers offer expertise in performing certain manufacturing functions only and do not perform functions such as

[73] *EU* 2014c, sec. 3.1.3.

materials purchasing and production scheduling. Moreover, they usually do not face direct market risk because they have a guaranteed revenue stream from the customer with which they have concluded an agreement. Accordingly, their remuneration is on a fee basis (cost plus), or on a pre-established price per unit. The intangibles of toll manufacturers are limited and typically consist of know-how related to the manufacturing processes. Due to all these characteristics, the rate of return received by toll manufacturers is generally significantly lower than the rate of return received by a fully-fledged manufacturer. The Commission expressed doubts regarding Starbucks Manufacturing BV being considered as a low-risk toll manufacturer related to the fact that the inventories, though considered as being in consignment, appeared in the balance sheet and Starbucks Manufacturing BV records provisions for losses of inventory value. The relevant risks were not shifted from the Netherlands. An additional doubt with regards to the toll manufacturing arrangement was about the costs of raw materials (COGS) that were treated as pass-through costs, contrary to the OECD Guidelines, which indicates that full costs or operating expenses may be an appropriate base for a service or manufacturing activity and that they are often used in similar circumstances.[74]

Using adjustments to decrease the tax base for the application of the mark-up rate actually resulted in a lower mark-up and, moreover, using complicated and separate calculations for functions performed by Starbucks Manufacturing BV, excess remuneration was not attributed to it, but was transferred to Alki LP for the risk of taking title to raw material.[75] Another doubt about the appropriateness of the adjustments referred to the similarity of both adjustments, so the Commission concluded that they addressed the same comparability concern and, therefore, "one of those adjustments seems redundant"[76]. Other important suspicions the Commission expressed were: (i) the assumption from the transfer pricing study that EURIBOR is a risk-

[74] *OECD* 2010, para 2.87 and 2.93.

[75] In spite of the fact that it was not documented in the file. Furthermore, this structure provides that a function allegedly performed in Switzerland would be remunerated in the UK, where Alki LP is established. It means that income will be taxed in the countries of the tax residences of its partners.

[76] *EU* 2014c, para 98.

free rate[77] so further spread was added to it (50 basis points without explanation); (ii) adjustment of the costs relating to the employees of Starbucks' Swiss subsidiary performing the sourcing activities, even though these costs were not part of the operating costs of Starbucks Manufacturing BV; and (iii) adjustment for the working capital which was not made based on working capital figures.[78]

Therefore, the Commission considered that Starbucks Manufacturing BV did not comply with the arm's length principle and it obtained an advantage from the Dutch authorities since these measures appeared to constitute a reduction of remuneration that normally should be borne by independent parties.

4. POSSIBLE CONSEQUENSES FOR THE CROATIAN TAX ADMINISTRATION

The financial goals of multinational enterprises are important issues that shape transfer pricing policies. Managing cash flows, funding capital expansion, paying interest on debt, encouraging research and development, supporting stock option plans and funding dividend payments to shareholders, require placing income in the legal entity where the funds are required. If this allocation of income is based on overriding business reasons for wanting to place functions, risks and assets (mainly intangible) in certain locations due strictly to tax motives and ignoring economic reality, the transfer prices resulting from such circumstances will not be accepted by tax authorities. The gap between substantial profits on a corporate level (consolidated accounts shown to investors and analysts), and tax losses reported to the tax authorities, can be a result of tax planning techniques that are inspired by governments. However, the same difference may be a result of taxpayers' tax planning that is not accomplished in accordance with the spirit of the tax legislation. If, for example, a taxpayer decreases its tax base

[77] Euro Interbank Offered Rate. The Euribor rates are based on the average interest rates at which a large panel of European banks borrow funds from one another, so it includes the applicable risk premium (*Euribor-rates.eu*).
[78] *Ibidem.*

due to investments in research and development, or the training of employees, it is often recognised by tax authorities as a desirable tax cut. But, if a taxpayer reports consolidated profits with little or no tax paid in a certain country owing to complicated and artificial tax planning schemes, then it will be considered as tax avoidance inconsistent with the intent of the law.

However, there is a fine line between the two that legislators and international leaders have to regulate in order to improve fairness and certainty in the global tax arena. Due to the complexity of the economic substance of the transactions and the dynamic global environment, legislators need time to clarify the issues.

Until tax administrations clarify the criteria and take another critical step towards safeguarding legal tax certainty, a general estimation of the tax risks for multinationals can be pointed out: those who have relied strictly on the letter of law using the principle "if they know it is too good to be true, they should be worried"[79]. More worries for corporate managers may arise from the words of Commissioner Moscovici, who said that the tax affairs of an additional 300 multinationals could potentially come under the Commission's scrutiny[80].

Unfortunately, additional tax risks are likely to be raised due to the impact of these investigations on the tax administrations of Member States. Following the announcements of the verdicts of Competition Commissioner M. Vestager on Starbucks and Fiat Finance and Trade, and welcoming the Commission's decisions, M. Ferber stressed that "the Member States who granted them also need to be punished", while M. Theurer pointed out that this verdict was not only issued "against Starbucks and Fiat, but also against Member States"[81]. Commissioner Margrethe Vestager herself said "I hope that, with today's decisions, this message will be heard by Member State governments and companies alike."[82] These strong words, coming from the the key TAXE MEPs, and Commissioner, might sound threatening for the tax administrations and governments of Member States.

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[79] Concretely, Heather Self, a tax partner at the law firm Pinsent Masons said: "Anyone who has got a ruling they know is too good to be true should be worried."(*Garside*, 2014).

[80] *Kavanagh and Robins* 2015, 370.

[81] *EU* TAXE Press release, 2015.

[82] *EC* Press release IP-15-5880.

In this way HMRC, for example, was blamed by the Parliamentary Committee for not pursuing all the tax due from big businesses, towards which it was too lenient[83]. The Dutch tax administration was also forewarned in the Commissions Letter[84] that tax authorities are responsible for the comparison of the method proposed by the taxpayer with "the prudent behaviour of a hypothetical market operator, which would require a market to confirm remuneration of a subsidiary or a branch, which reflects normal conditions of competition".

Maybe this might be an easy task for a modern European tax administration, such as the Dutch one, due to the fact that, in addition to its tradition and modernity, they operate at typical western European market standards and functions almost perfectly, with all the players being perfectly informed and acting as a simple *homo oeconomicus*.[85] However, bearing in mind the economic crisis in Croatia, and thousands of employers struggling to survive in the market, with thousands of employees not getting a salary for their work[86], together with a tax administration that has to grow from the "old" to a new, modern and sophisticated administration, one which serves taxpayers, in an uncertain environment of constantly changing tax legislation and the implementation of new legal tax instruments, it is reasonable to be sceptical. Croatia does not have strong, successful multinational companies established within the country, and suffers from low inward foreign direct investment, as well as from an important presence of foreign based multinational enterprises. Even the simple export of goods and services is considered as a success for Croatian entrepreneurs. Legal uncertainty and labour costs are very high, while the market is very small. All these factors combined together mean that market conditions and prerequisites for Croatian companies during negotiations on business deals with its counterparts can differ, with margins extremely volatile, largely dependable on weak negotiation positions and a strong willingness to compromise.

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[83] *UK* 2012b, para 3.

[84] *EU* 2014c, para 77.

[85] Which can hardly be true, due to the complexity of human behavior and even more complex market imperfections and rapid changes.

[86] *See*: List of the taxpayers/employers that, according to available information, do not give salaries to their employees (*CTA* 2015).

The CTA might be confused by such scrutiny from the EU Commission: on the one hand required to be a partner with taxpayers, and supportive to foreign investors and business, and on the other, instructed by supranational bodies to establish "the prudent behaviour" of entrepreneurs.[87] At the time when Croatian tax officers receive the first enquiries for binding rulings and answer them to their best of their knowledge, putting great efforts into understanding the business positions of the entrepreneurs who seek greater legal tax certainty, the development of such a supranational tax system within the EU might result in turning the administration's approach back to traditional scrutiny.

If tax administration officers are to understand EU instructions so as to act in a manner that strictly applies the best margin available, according to the evidence, on transactions within their country for each and every case, then businesses would depend on the tax bureaucracy's subjective interpretation of the tax bureaucracy relating to the market conditions which determine market prices, always with best case scenarios for the budget and worst case scenarios for taxpayers.[88]

In such a scenario it would be less harmful to establish "tax transfer prices" for all entrepreneurs in advance.[89] Consequently, every company should know what is acceptable as a revenue or a cost for tax purposes. Paradoxically enough, in some cases the result of these "prescribed transfer prices" might be a profit. It sounds like a very unpopular measure of a 'command economy', but it seems that it might be favourable for entrepreneurs to have clear guidelines of prices with affiliated companies

[87] Interestingly enough, some projects of the CTA were realised in cooperation with experts from the Tax and Customs Administration of the Netherlands (see: *CTA* 2011; *CTA* 2010).

[88] Every transaction with an affiliated company can be accomplished in both directions – a domestic company might be in a position to buy or sell from/to a foreign company. If buying and selling transactions are interpreted differently, depending on the consequences for the state budget, then it is better to have the same prices stipulated in advance, no matter the market conditions, but in favor of legal tax certainty and possible positive consequences for profitability. In other words, if every transaction is recognized by tax officials, with the fear of being accused of 'lenient treatment' and 'selective advantage' for a taxpayer, in accordance with the comparable data available only to the tax administration, at a price that the less it increases the budget income the more it increases taxable profit and tax payable.

[89] Within the scope of the arm's length principle for transfer prices it would mean, for example, determining margins and a basis for the application of these margins.

which they know in advance[90]. Under such conditions, entrepreneurs would have 'a clear picture' of future tax liability and a better chance to choose profitable transactions. Nonetheless, this would be contrary to the principles of taxation[91] and as such has a very low probability of realization.

Therefore, what can be expected consequent to the EU investigations into the CTA? How will it affect the issuance of binding opinions or the attitude towards big business, mainly multinational companies, in Croatia? First, binding opinions that could be issued by the CTA have a very narrowly defined scope of subjects, as explained *supra*, where an APA is not an option so it is not possible to sign advance agreements on transfer pricing.[92] As the CTA had always been reluctant to prescribe APAs, bearing in mind recent EU investigations, it is hard to believe that such tax arrangements would be allowed in the near future. Moreover, if we imagine how negatively the Commission's investigations and warnings may influence the CTA, then this might be hypothetically visible as a change during tax audits, where tax inspectors might change (or pursue) their behaviour with the simple aim of using the best case scenario for the Croatian budget as the only "economic substance", with benchmarking analysis in accordance with the transactions from the market that best fit. Conducting an audit in such a manner will be accepted from the public as well as from the EU Commission. However, it is also possible that the CTA, after years of training and practice, will act confidently, recognising instructions from the EU as guidelines and assistance in better understanding transfer pricing issues, at the same time as supporting business with legal tax certainty.

Without any prejudice against the tax avoidance of multinationals and against European tax administrations, the mere fact that well-known tax

[90] The market prices in such cases are not the same as prices that would be recognized for taxation purposes, but this information would be crucial for taxpayers to calculate the taxable profit and plan their activities in advance.

[91] As pointed out in the analysis of Starbucks' transfer prices (but not in the same context): "If the same logic is followed, the business of the company could be considered as low-risk because there would be no variation of the tax liability between fiscal years. However, such a lump sum payment could hardly be reconciled with the underlying economic reality of the transactions and the risks of the business activity and could not be reconciled with the principles of taxation. "(EU EC Letter, 2014, recital 88).

[92] As explained in the letter of Mr. Lalovac (Croatian Minister of Finance) to TAXE Special Committee (*MF*, 2015).

administrations within the EU have been warned about the distortions of competition through selective tax advantages given to some enterprises, raises the question as to the possible consequences for tax administrations in developing countries and decreases tax safety for entrepreneurs. Partnership and cooperation between the tax administration and taxpayers in Croatia are at the rudimentary stage, so this fragile phase can be easily threatened by potential accusations from European authorities.

5. CONCLUSION

The basic principles of an actual international tax regime were laid out at the first Model convention issued by the League of Nations, based on the report of four economists in March 1923[93]. This, almost 100 year-old, concept of taxation needs to be modernised. The OECD, the G20 and the EU have taken the initiative, and it seems that nothing can stop the process of the implementation of fairness in taxation in the globalized arena, not even the threats of the scrutiny of tax administrations which could slow down economic recovery.

While transfer pricing represents the most complex and fluid issue in tax practice, when combined with intellectual property, and hybrid mismatch arrangements together with considerable amounts of international trade employed, it goes without saying that a number of actions were undertaken to combat the aggressive tax planning of multinationals. The EU has found a new modus operandi to deny benefits in the case of harmful transfer pricing arrangements with the tax administrations of Member States, namely compatibility with state aid rules.

Traditionally 'tax friendly' countries, which have a well-developed and consistent practice providing security to tax payers, have been warned by these actions of the OECD and the EU about certain behaviour which is no longer considered acceptable. The ability of these countries (as well as MNEs) to adapt to new circumstances is undoubtable.

Nonetheless, there is a question as to how, with such turnarounds in tax policy, the EU states still in development will manage. One can assume that the tax authorities of countries in transition, which are trying to catch up

[93] *Bogovac* 2014, 111.

with modern administrations, would find themselves in a difficult situation adjusting the process of 'partnership with taxpayers' to the new direction of fighting against tax evasion. The CTA has made great efforts in developing better relations with taxpayers, while introducing instruments that reduce tax risk. Now that it is these instruments to increase legal tax safety (such as binding opinions) which have become the subject of the scrutiny of the EU, the focus has shifted to instruments which prevent tax evasion, to the detriment of 'partnership' and the legal certainty of taxpayers.

The very complex system of unreliable allowances and the incompatibility of tax systems makes it extremely difficult for businesses to take long-term investment decisions, while decisions they have already made for undertakings that are now part of their everyday business life are under the unexpected scrutiny of the OECD and EU officials.

The ratio of trust between tax administrations and taxpayers is one of the important ratios in the increase of tax avoidance. In such a manner as to identify it, Jelčić finds that, in Croatia, the tax administration and its attitude towards taxpayers are unprofessional, unconscionable and non-objective, as well as inefficient and arrogant[94]. Following the path of tax avoidance, whether conducted with or without the intention of taxpayers, the tax administration increases the number of investigations and treats all taxpayers with more scrutiny, creating a vicious circle of constant antagonism between taxpayers and tax authorities[95]. Since the EU fiscal state aid investigations put pressure on both subjects of the tax system (the taxpayers as well as tax administrations) they constitute an additional accelerant in this vicious circle of taxation. This may give rise to a lengthened period of uncertainty for business and tax authorities, especially in developing countries, due to their struggles in identifying what constitutes 'economic reality' or 'market conditions' in accordance with newly established supranational standards.The categories and values ascribable to the rule of law, such as predictability and legal certainty in the tax field, are now at very low levels, as a new era begins of taxation regarding big business.

[94] Jelčić et al. 2008, 216.
[95] Bogovac 2015, 268-269.

While the Croatian economy shows some signs of recovery,[96] we can only hope that the hard-earned profits of entrepreneurs will not be lost in tax disputes with the CTA.

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Sažetak

ISTRAGE O NEZAKONITIM DRŽAVNIM POTPORAMA U OPOREZIVANJU I MOGUĆI UTJECAJ NA HRVATSKU POREZNU UPRAVU

U članku su prikazane nedavno pokrenute istrage EU-a o transfernim cijenama kod oporezivanja dobiti nekih multinacionalnih korporacija. Ove istrage ispituju jesu li odluke poreznih uprava Irske, Nizozemske i Luksemburga (u vezi s Appleom, Starbucksom i Fiat Finance and Tradeom) sukladne EU-pravilima o državnim potporama. Potaknute naporima OECD-a i porasta javne kritike na nepoštenu alokaciju poreznog tereta između multinacionalnih korporacija i manjih, tuzemnih poduzeća i stanovništva, Europska je komisija u posljednje dvije godine poduzela mjere s ciljem uvođenja više pravednosti u oporezivanje porezom na dobit u Europi. Ovaj članak proučava utjecaj trenutnih međunarodnih napora u ponovnom uređivanju globalnog poreznog sustava, na hrvatsku Poreznu upravu, koja nastoji držati korak u harmonizaciji s Europskim poreznim pravom, praksom i partnerskim odnosom s poreznim obveznicima.

Ključne riječi: *fiskalna potpora; EU istrage; Porezna uprava Republike Hrvatske.*