

A Step towards a Fair Corporate Taxation of Groups in the Emerging Global Market

Maarten F. de Wilde¹

1 Introduction

The international corporate income and capital gains tax systems (hereinafter: 'international tax systems') of basically all modern democratic constitutional nation states share a common objective. All seek to effectively 'capture' groups or multinational enterprises ('MNEs') that are economically present within the respective taxing state's geographical borders for corporate tax purposes. In their operation, however, these systems typically subject groups to different corporate tax treatment depending on their legal structuring or the question of whether the business operations are performed in a (non-)cross-border context. This affects the corporate tax burden imposed, which in turn influences the distribution of production factors. And this affects corporate tax revenues. In individual cases things may work out for the benefit or to the detriment of individual MNEs or tax authorities (depending on the team one roots for). If observed as a whole, it can nevertheless be said that the international tax systems of states distort the functioning of domestic markets, the internal market within the European Union ('EU') and the emerging global market. Corporate taxation basically spills over to all sides. This is problematical for all parties involved in the corporate taxation of proceeds from multinational business operations. Everyone pays at the end of the day.

In this article, I address the question of how states may mitigate the distortions they unilaterally impose when taxing MNEs on the corporate business income earned and the capital gains realized within their respective territories. I will argue that an answer to this question ideally lies in *in jure* tax consolidation: treating the MNE as one for corporate tax purposes. At the heart of the reasoning lies the thesis that the separate entity approach needs to be abandoned in favor of adopting a unitary business approach. This would enable the economic entity, i.e. the MNE, to be treated as the taxable unit. For the purpose of defining the group for corporate tax purposes, it is argued that tax consolidation should occur with respect to: a) corporate interests that provide the ultimate parent company with a decisive influence over the underlying business affairs of its subsidiaries, provided that; b) the parent company holds its corporate interest as a capital asset. In addition, tax consolidation should be allowed in both domestic and cross-border scenarios ('global consolidation'). Following the building blocks for an internally equitable and capital-neutral international tax system which I advocated earlier in *Intertax*,² it is further argued that the group should be subject to an unlimited corporate tax liability in each taxing jurisdiction in which it exceeds a minimum threshold of economic activity. In cross-border scenarios, double tax relief should subsequently be provided for on the basis of the methodology referred to as the credit for domestic tax attributable to foreign income.

Such an approach would enhance fairness in the corporate taxation of groups. It would bring the corporate tax treatment of corporate groups and single corporate entities up to the exact same level in both domestic and cross-border scenarios. That would cancel out all unilaterally imposed distortions in the corporate taxation of MNEs. Corporate tax burden and revenue levels would not be influenced by the MNEs' legal structuring or the question of whether business is conducted in a domestic or cross-border context. To that extent, spill-over effects would be eliminated. However, the advocated approach provides just part of an answer to the distortive allocation of corporate tax among taxpayers and between states in a globalizing economy. It is just a first step. Not all distortive features of international taxation would be resolved. It would not provide an answer to the market distortions caused by disparities or obstacles imposed abroad. Moreover, it would not provide an answer to the distortions caused by the inadequacies in the methodology generally employed by states to mutually divide the 'international tax pie'. Although the legal structuring of the MNE's business activities would cease to influence the territorial

¹ LL.M, Erasmus University Rotterdam, Utrecht University and Loyens & Loeff NV, Rotterdam, the Netherlands. The author can be reached for comments at: dewilde@frg.eur.nl.

² See Maarten F. de Wilde, *Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy*, 38 *Intertax* 281 (2010).

allocation of business profits, it would not solve the allocation issues themselves. It would remain problematic to properly allocate business profits, for instance the MNEs' firm-specific rents, to taxing jurisdictions as the allocation process would still take place under the generally applied but fairly criticized concepts of permanent establishment and the at arm's length principle. It would also remain problematic to adequately tax proceeds from inbound investments by third party shareholders, creditors, and lessors in the source state. Finally, it would not provide for a solution to the current arbitrary differences in the corporate tax treatment of third-party debt and equity financing arrangements. However, the first piece may be considered to have fallen into place. This paves the way for discovering the place of the remaining pieces in the international tax puzzle.

2 International tax systems' operation distort the attribution of production factors

As mentioned in the introduction, the international tax systems of sovereign states in effect seek to capture MNEs economically present within the respective taxing state's geographical borders.³ All attempt to geographically localize business activities and the business income produced. The purpose is to ensure that business income generated within the territory of the taxing state is taxed by that state. Business income generated outside that state's territory – i.e. foreign source income – is generally intended to be excluded from domestic taxation.

States have established their international tax systems on common building blocks to attain this objective. Corporate entities are individually taxed on their earnings, i.e. the (functionally) separate entity approach. Resident corporate taxpayers are subject to unlimited tax liability and are taxed on their worldwide earnings. Juridical double tax relief is available for these taxpayers' foreign income items. Non-resident taxpayers are subject to limited tax liability and are taxed on their income derived from domestic sources, e.g. proceeds from business operations carried on through a permanent establishment situated within the taxing state. Proceeds from intra-firm dealings are distributed amongst the affiliated taxable units under the at arm's length principle. Whenever considered necessary, various correction mechanisms have been put in place (e.g. participation exemption, indirect credit, interest deduction limitation regimes, et cetera).

In their operation, however, the international tax systems of states arbitrarily affect corporate tax burdens and revenue levels. First, the corporate tax treatment of corporate groups typically differs depending on the manner in which these economic entities legally structure their business operations. This influences decisions on the legal forms chosen. Second, corporate tax implications typically differ depending on whether the economic activities are carried on in a (non-)cross-border context. States for instance subject taxpayers to different tax burdens depending on their place of residence (indirect discrimination) or whether that taxpayer's business operations are conducted across various tax jurisdictions (jurisdiction entry/exit restrictions). This affects the economic entity's decision as to whether or not to cross the tax border. Accordingly, corporate taxation influences the distribution of the production factors of capital and labor.

In individual cases this arbitrariness in corporate taxation may work out for the benefit of or to the detriment of individual MNEs or tax authorities. Observed as a whole, however, it can be said that the international tax systems of states unilaterally distort the functioning of domestic markets, the internal market within the EU and the emerging global market. In the end, the imposition of such obstacles harms all parties involved in the corporate taxation of proceeds from multinational business activities. The steady flow of case law from the Court of Justice on the fundamental freedoms in the field of direct taxation in cases falling within the scope of application of the Treaty on the Functioning of the European Union (TFEU) may be considered a noteworthy illustration of this.

3 Considerations of fairness within an international tax system

³ The income taxation of individuals and the relationship between corporate income and capital gains tax and individual income and capital gains tax are not considered here.

The question arises of how to remove these obstacles. How may states mitigate the distortions they unilaterally impose when taxing MNEs on the corporate business income earned and the capital gains realized within their respective territories? Or conceptually: how can one achieve fairness within a state's international tax system with respect to the corporate taxation of MNEs that are active within their territories?

An attempt to answer this question first requires answering the question of what is considered fair. Fairness in taxation is founded on the equality principle.⁴ Economically equal circumstances *in se* should be treated equally for tax purposes and unequal economic circumstances *in se* should be treated unequally to the extent of the circumstances being unequal. From the equality postulate it can be deduced that everyone in an economic relationship with a taxing state has the obligation to contribute to the financing of public goods from which one benefits in accordance with one's means ('equity').⁵ Concurrently, the distribution of production factors should take place on the basis of market mechanisms without, or at least with as little as possible, public interference ('economic efficiency'). Taxation should follow economic reality, rather than driving it. It should not affect business decisions, neither in a positive nor in a negative manner (tax neutrality, including the neutrality of legal form).⁶ Unequal tax treatment in equal economic circumstances accordingly is both inequitable and economically inefficient. The TFEU may be considered illustrative in this respect as it simultaneously calls for fair (*i.e. equitable*) and free (*i.e. economically efficient*) competition within the internal market.

In this paper I seek to define fairness *within* an international tax system. The reality of sovereignty at nation state level in the field of direct taxation is a given. This entails that the necessary consequences of this supposition are also a given. This is for instance true regarding disparities. Disparities are market distortions that occur due to mutual divergences between the international tax systems of states (such as mutual divergences in the taxable unit, base, and rate, as well as mutual divergences in the application of the international taxing principles of nationality, source and residence). Disparities entail different tax burdens imposed on proceeds from cross-border economic activities in comparison with proceeds from purely domestic economic activities. This affects the distribution of production factors. Typically, this is considered problematical. However, it should be recognized that logic prescribes that disparities can only be considered problematical if one is also willing to encroach on the sovereignty supposition as disparities may only be removed through harmonization, *i.e.* an event necessarily requiring the limitation of nation state sovereignty in direct taxation. Illustrative in this regard is the occurring strain within the context of the EU where the EU Member States on the one hand express the objective to approximate (tax) legislation requiring a transfer of sovereignty to the EU, while the same Member States on the other hand seek to maintain their competence to levy direct taxes (illustrated by the Member States' unanimity vote regarding the passing of EU tax legislation).

The following four hypotheses can be deduced from the equality postulate while respecting the tax sovereignty supposition:

1. A state should subject a group of affiliated corporate entities which jointly operate a business enterprise to an overall tax burden that is equal to the tax burden to which a single corporate entity operating a business enterprise is

⁴ I substantiated this earlier in Intertax. See De Wilde, *supra* note 2, at section 4.

⁵ See for a comparison Klaus Vogel, *Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Parts I, II & III)*, 8/9 Intertax 216 (1988), at p. 216-228, 10 Intertax 310 (1988), at p. 310-320 and 11 Intertax 393 (1988), at p. 393-402. See for a comparison also Wolfgang Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1 WTJ 67 (2009), at section 2.

⁶ The neutrality of legal form is required as legal aspects are superfluous when it comes to determining the amount of earnings. Corporate taxes seek to tax profits. At the end of the day, legal aspects (e.g. (un)limited liability for company law purposes) are of no relevance for answering the question of how much money has been made. It is true that, for instance, the limited liability that entails from the operation of economic activities through corporations/subsidiaries enables greater economic risks to be taken with the effect of a potentially higher profit level. However, limited liability itself is irrelevant in determining the amount of profits earned. Legal reality should therefore be of no relevance for the purpose of determining the level of *taxable* profits. Contra general reporter Masui in: International Fiscal Association, *Cahiers de Droit Fiscal International*, Volume 89b, *Subject II (Group taxation)*, SDU Fiscale & Financiële Uitgevers Amersfoort, the Netherlands, 2004, at p. 35-36.

subject (the ‘unitary business approach’).⁷ Notably, one may speak of a group in the event that the business activities of the aggregate of corporate entities are integrated financially, economically and organizationally into one economic entity. In that event, the aggregate of corporate entities constitute one economic operator, i.e. the group (or MNE when the group is active in a cross-border context), operating an integrated business enterprise;

2. Income produced should only be taxed once by a single state (the ‘single tax principle’).⁸ Income should be subject to neither double nor less than single taxation. This holds true in both domestic and cross-border scenarios;
3. A state should subject groups to corporate taxation (to contribute to the financing of public goods from which they benefit) to the extent that their economic presence within that state exceeds a certain minimum threshold (the ‘origin principle’).⁹ That state should refrain from taxing the group’s economic presence abroad. Notably, (for now) the methodology that is commonly operated for the purpose of identifying that threshold and to mutually divide the corporate tax base between states is deemed not to encroach on the origin principle. The applied source concepts (e.g. the permanent establishment threshold) and profit allocation (i.e. transfer pricing) methodology are deemed to operate in accordance with economic reality. This assumption enables me to delimitate the remaining challenges from the solutions put forward in section 6.3;
4. If a state exercises its taxing powers on a group that meets the economic presence threshold, the domestic tax burden on the income earned by that group should be the same, irrespective of whether the group conducts its business activities in a (non-)cross-border context (‘internal equity’ / ‘capital neutrality’).¹⁰ The domestic tax burden on income earned out of cross-border business activities should be equal to the domestic tax burden on income earned out of non-cross-border (i.e. purely domestic) business activities. This holds true regardless of the direction of the investment, thus with respect to both origin (i.e. outbound investments) and host state (i.e. inbound investments) scenarios. Accordingly, it should be irrelevant where the group is seated.¹¹ It should also be irrelevant whether the group earns its business income solely within the taxing jurisdiction or across various (taxing) jurisdictions.¹²

4 Tax consolidation remedies the separate entity approach’s distortive features

⁷ See Jinyan Li, *Global Profit Split: An Evolutionary Approach to International Income Allocation*, 50 Can. Tax J. 823 (2002), at p. 826.

⁸ See for a comparison Reuven S. Avi-Yonah, *Tax Competition, Tax Arbitrage and the International Tax Regime*, 61 Bulletin for International Taxation 130 (2007), at p. 131. See also Reuven S. Avi-Yonah, *International Tax as International Law; An Analysis of the International Tax Regime*, Cambridge University Press, New York, 2007, at Chapters 1 and 10, as well as Klaus Vogel, “State of Residence” may as well be “State of Source” – There is No Contradiction, 59 Bulletin for International Taxation 420 (2005), at p. 420-423.

⁹ *Ibidem*. See also Eric C.C.M. Kemmeren, *Source of income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach*, 60 Bulletin for International Taxation 430 (2006), at p. 430-452 and E.C.C.M. Kemmeren, *Renteaftrek is niet het probleem in de vennootschapsbelasting; wel het niet-belasten van rente!*, WFR 2009/401, at sections 1 and 6.

¹⁰ See De Wilde, *supra* note 2, at section 6. Conceptually, I telescope capital import neutrality (CIN) and capital export neutrality (CEN) into one another.

¹¹ International tax systems based on CEN (where worldwide income is taxed and a credit for foreign tax is granted) distort the competitive position of foreign economic operators in the source state. Hence, the conceptual basis for these systems is inequitable and inefficient as these systems unilaterally distort *inbound* capital movements in the source state. See Klaus Vogel, *Which Method Should the European Community Adopt for the Avoidance of Double Taxation?*, 56 Bulletin for International Taxation 4 (2002), at p. 5. In the Netherlands, this constitutes the traditional argument under which CEN is rejected as a default neutrality principle for the purpose of eliminating double taxation with respect to foreign source business income, see e.g. the letter of the Dutch State Secretary to Parliament of Finance of 26 October 2009, DB09-624. See for details on this matter De Wilde, *supra* note 2, at section 6.3.1.

¹² In a territorial taxing system, based on CIN (where income realized within the source state is taxed and foreign source income is not taken into consideration), the tax burden differs depending on whether the economic operator realizes its business income solely within the respective taxing state or across various states. Hence, the conceptual basis for territorial tax systems is inequitable and inefficient as these systems unilaterally distort *outbound* capital movements from the source state to abroad (dislocations). See for details De Wilde, *supra* note 2, at section 6.3.1.

Typically, states maintain the approach of taxing corporate entities on an individual basis if these entities belong to a group.¹³ This influences the group's decisions on the manner in which it (legally) arranges its business affairs. The separate entity approach distorts the choice of legal form.¹⁴ Viz., a comparison between a group of affiliated corporate entities operating a business enterprise and a single corporate entity operating a business enterprise reveals that the separate entity approach entails different corporate tax treatment in comparable circumstances. Groups and single entities are taxed differently, despite the fact that they are subject to economically equal circumstances. Legal transactions between the corporate affiliates (intra-group transactions) are recognized as a taxable event for corporate tax purposes. An at arm's length transfer price needs to be considered with respect to intra-group provisions of services and supplies of goods. This is not the case with the equivalent 'dealings' between the branches of a single legal entity (internal dealings). Internal dealings are disregarded for corporate tax purposes. In addition to this, intra-group distributions of after-tax corporate earnings, i.e. intra-group dividends and intra-group capital gains on shareholding interests, issued for the purpose of reinvestment in the group's business enterprise, are considered as taxable events as well. No such taxable event occurs where a single entity reinvests its branches' after-tax earnings in the single entity's business enterprise. Moreover, an aggregation for corporate tax purposes of the group's business income (i.e. an aggregation of losses and profits realized by the various affiliates within the tax year: 'horizontal loss-compensation') is denied where the aggregation of the business income earned through the single legal entity's branches is granted. Consequently, groups are put at a competitive disadvantage as the different corporate tax treatment in comparison with single entities results in liquidity (cash flow) disadvantages and the economic double taxation of the business income realized by the group. Groups and single entities in comparable circumstances are subject to a different tax burden. This is unfair.

Tax legislators in various states recognize the distorting effects that the application of the separate entity approach to groups entails. Equity and economic efficiency considerations inspired several to remedy the distortions through the application of tax consolidation regimes for groups of companies.¹⁵ Without the intention of being conclusive, tax consolidation regimes can, for example, be found in the international tax systems of France ('régime de l'intégration fiscale' and 'régime du bénéfice mondial consolidé'),¹⁶ Italy ('consolidato fiscale nazionale' and 'consolidato mondiale'),¹⁷ Luxembourg (régime d'intégration fiscale),¹⁸ the Netherlands ('fiscale-eenheidsregime'),¹⁹ the United States ('privilege to file consolidated returns'),²⁰ Australia ('consolidated groups'),²¹ New Zealand ('consolidated groups of companies')²² and Japan ('consolidated tax return filing system').²³ In addition to this, the efforts of the European

¹³ See for a comparison Wolfgang Schön, *International Tax Coordination for a Second-Best World (Part II)*, 2 WTJ 65 (2009), at p. 71.

¹⁴ See for a comparison Maarten F. de Wilde, *On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test*, 19 EC Tax Review 170 (2010), at section 3.

¹⁵ On group taxation see International Fiscal Association, *supra* note 6. In distinguishing group taxation regimes, general reporter Masui distinguishes the 'Organschaft', 'group contribution', 'group relief' and the 'consolidation model' on p. 29. In this article I focus on tax consolidation as this is the only model conceptually paving the way to recognize the group as a single taxable unit and with that to fully appreciate the unitary business approach. At the end of day the other approaches referred to all are profit-pooling regimes certainly deviating from the separate entity approach yet not recognizing the unitary business approach to its full extent conceptually since intra-group legal transactions in their essence maintain to be recognized for corporate tax purposes.

¹⁶ See respectively Article 223A of the French Code Général des Impôts ('French CGI') and Article 209 quinquies French CGI.

¹⁷ See Articles 117-142 of the Italian Testo Unico delle Imposte sui Redditi ('Italian Tax Code' or 'TUIT').

¹⁸ See Article 164bis of the Luxembourg Loi de l'impôt sur le Revenu (Luxembourg Income Tax Law, hereinafter: 'Luxembourg ITL' or 'LIR').

¹⁹ See Article 15 of the Dutch Wet op de vennootschapsbelasting 1969 ('Corporate Income Tax Act 1969 or 'Dutch CITA').

²⁰ See §§1501–1564 (Consolidated Returns) of the United States Internal Revenue Code ('US IRC').

²¹ See Division 703 (Consolidated groups and their members) of the Australian Income Tax Assessment Act 1997 ('Australian IITA 1997'). See also Division 719 (MEC groups) Australian IITA 1997 with respect to the formation of consolidated groups of wholly owned subsidiaries of a foreign tax resident parent company (a 'multiple entry consolidated' ('MEC') group).

²² See Subpart FM (Consolidated groups of companies) of the New Zealand Income Tax Act 2007 ('New Zealand ITA').

²³ See Article 4-2 (Consolidated taxpayer) of the Japanese Corporation Tax Act ('Japanese CTL').

Commission to adopt a harmonized corporate tax base for European business enterprises in combination with a tax consolidation regime, referred to as the Common Consolidated Corporate Tax Base, or CCCTB, should be mentioned here as well.

The application of a full tax consolidation regime basically entails that the business economics reality of the group as one economic operator operating an integrated business enterprise is acknowledged for corporate tax purposes. The unitary business approach is adopted as a correction mechanism for the distortive effects that ensue from adopting the separate entity approach as a point of departure. Full tax consolidation conceptually has the effect that the group of affiliated corporate entities is treated as a single entity for corporate tax purposes and accordingly regarded as the taxable unit. The corporate veils are being pierced for tax purposes. The parent company constitutes the taxpayer; all affiliated corporate entities are effectively tax transparent ('all-in approach'). Due to this, the group is taxed in the same manner as a single corporate entity that is conducting its business enterprise through branches. Tax consolidation allows for the aggregation of losses and profits realized by the various affiliates within the tax year. Furthermore, tax consolidation takes back the initial recognition of intra-group transactions for corporate tax purposes. As a result thereof, tax consolidation allows groups to organize their business affairs (legally) to meet their commercial needs without corporate taxation distorting this. The single taxation of the business income of groups is achieved in an equitable and economically efficient manner. The market distortions that ensue from applying the separate entity approach are resolved. Economically comparable circumstances are treated equally for corporate tax purposes. Economic reality is appreciated. This is fair.

Notably, tax consolidation also resolves the market distortions that occur from the arbitrary, yet commonly applied, differences in the corporate tax treatment of proceeds from debt and equity financing arrangements. Most international tax systems do not take proceeds from equity financing arrangements into account for corporate tax purposes (i.e. non-taxed dividend receipts and capital gains on (substantial) corporate shareholders interests / non-deductible dividend payments and impairments on such shareholders' interests), on the one hand, but recognize debt financing arrangements for corporate tax purposes, on the other (i.e. taxable interest receipts / deductible interest payments and impairments of receivables).²⁴ Tax consolidation remedies this arbitrary corporate tax treatment, at least to the extent that it concerns *intra-group* debt and equity financing arrangements. Financing arrangements within a group of affiliated corporate entities should not be recognized for corporate tax purposes as they do not affect the overall business profit realized by the group: intra-group dividend streams or interest payments do not add value to the economic entity. Hence, there is no economic reality that could support the recognition of intra-group interest payments or dividend distributions for corporate tax purposes. Under the separate entity approach, however, intra-group financing arrangements are recognized for corporate tax purposes. This effect is remedied when tax consolidation is applied. After all, derecognizing intra-group transactions for corporate tax purposes entails that intra-group (debt and equity) financing arrangements are derecognized as well.

The aforementioned distortions are kept in place in cases where a state's international tax system does not allow groups to be regarded as a single taxable unit. This may be the case when the respective taxing state simply does not have a tax consolidation regime available in its international tax system, or does not allow a group to apply the tax consolidation regime and form a consolidated tax group under the terms of the regime's application. In such cases, the separate entity approach is maintained. Liquidity (cash flow) disadvantages and the economic double taxation of the business income realized by the group will then be the inevitable consequence.

²⁴ See Schön, *supra* note 13, at p. 74-76. See on this matter also Ruud de Mooij & Michael Devereux, *An applied analysis of ACE and CBIT reform in the EU*, CPB Discussion Papers 128, CPB Netherlands Bureau for Economic Policy Analysis, 2009. Moreover, see for a comparison A. Van der Horst en R.A. de Mooij, *Een macro-economische analyse van renteaftrek in de Vpb*, WFR 2009/948, at section 2. Notably, the Dutch government has been struggling with the distortive consequences of these arbitrary differences in corporate tax treatment since the Court of Justice rendered its decision in case C-168/01 (Bosal). See the letter of the Dutch State Secretary of Finance to Parliament of 15 June 2009, DB/2009/227U ('Consultatiedocument') and the Letter of the Dutch State Secretary of Finance to Parliament of 5 December 2009, DB2009/674 M (commonly referred to in Dutch tax practice as 'Sinterklaasbrief'). The 'Sinterklaasbrief' has been published in English and is available at: <http://www.rijksoverheid.nl/documenten-en-publicaties/kamerstukken/2009/12/22/english-version.html>.

In scenarios where firms are not enabled to form a consolidated tax group, states commonly counter the resulting distortions on the basis of alternative, specific or *ad hoc*, correction mechanisms, all of which have been introduced for equity and/or economic efficiency reasons. For example, single taxation on proceeds from *equity* interests in (non-consolidated) group companies - such as intra-group dividends and capital gains - is commonly achieved by states on the basis of an indirect credit or a participation exemption mechanism (regularly in conjunction with the application of a 0% dividend tax rate or dividend tax exemption with respect to intra-group dividend distributions). Participation exemption regimes can, for example, be found in Australia²⁵ Luxembourg,²⁶ the Netherlands,²⁷ France,²⁸ Belgium,²⁹ Austria,³⁰ Denmark,³¹ Finland,³² Norway,³³ Germany,³⁴ Italy³⁵ Spain,³⁶ and Japan.³⁷ (Dividend) imputation credit regimes can, for example, be found in New Zealand³⁸ and the United States.³⁹ The EU Parent

²⁵ See section 23AJ (Certain non-portfolio dividends from foreign countries not assessable) Income Tax Assessment Act 1936 ('Australian IITA 1936') and Subdivision 768-G (Reduction in capital gains and losses arising from CGT events in relation to certain voting interests in active foreign companies) Australian IITA 1997, providing for relief for dividend income and capital gains on the disposal of shares. Eligibility criteria are left out of consideration.

²⁶ See Articles 147 and 166 Luxembourg ITL. Under its participation exemption regime, Luxembourg applies a full exemption both with respect to dividends and capital gains. Eligibility criteria are left out of consideration.

²⁷ See Article 13 Dutch CITA. Under its participation exemption regime, the Netherlands applies a full exemption both with respect to dividends and capital gains on shares. Eligibility criteria are left out of consideration. See for some details, Geert T.W. Janssen & Maarten F. de Wilde, *Key practical issues to eliminate the double taxation of business income; The Netherlands*, to be published as the Netherlands branch report regarding the 2011 IFA Congress, at sections 1 and 3.

²⁸ See Articles 145 and 216 French CGI. Under its participation exemption regime, France applies a 95% exemption with respect to both inter-corporate dividends and capital gains realized on the disposal of shares. Eligibility criteria are left out of consideration.

²⁹ See Articles 202-205 of the Belgian Wetboek van de inkomstenbelastingen 1992 (Belgian Income Tax Code 1992, hereinafter 'Belgian ITC' or 'WIB 1992'). Under its participation exemption regime, Belgium applies a 95% exemption with respect to inter-corporate dividends. Capital gains on substantial shareholdings are fully exempt from corporate income tax. Eligibility criteria are left out of consideration.

³⁰ See §10 of the Austrian Körperschaftsteuergesetz 1988 ('Austrian Corporate Tax Code' or 'KStG'). Under its participation exemption regime, Austria applies a full exemption both with respect to dividends and capital gains on shares. Eligibility criteria are left out of consideration.

³¹ See §13 of the Danish Selskabsskatteloven (Danish Corporation Tax Act, hereinafter: 'Danish CTA'). Denmark fully exempts inter-corporate dividends and capital gains on shares and §9 of the Aktieavancebeskatningsloven ('Danish Act on Taxation of Capital Gains and losses on Shares'). Eligibility criteria are left out of consideration. For details see, Thor Leegaard, *Taxation of Corporate Shareholders in the Nordic Countries – part 1*, 47 European Taxation 126 (2007), at p. 126-134 and Thor Leegaard, *Taxation of Corporate Shareholders in the Nordic Countries – part 2*, 47 European Taxation 178 (2007), at p. 178-186.

³² See §§6-6b of the Finnish Business Income Tax Act ('Lag om beskattning av inkomst av näringsverksamhet' or 'NSL'). Under its participation exemption regime, Finland applies a full exemption both with respect to dividends and capital gains on shares. Eligibility criteria are left out of consideration. For details, see Leegaard, *supra* note 31, at p. 126-134 and Leegaard, *supra* note 31, at p. 178-186.

³³ See §2-38 of the Norwegian Skatteloven ('Norwegian Tax Act' or 'Norwegian TA'). Under its participation exemption regime, Norway generally applies a full exemption both with respect to dividends and capital gains on shares. Eligibility criteria are left out of consideration. For details see Leegaard, *supra* note 31, at p. 126-134 and Leegaard, *supra* note 31, at p. 178-186.

³⁴ See §8b of the German Körperschaftsteuergesetz ('German Corporate Tax Code' or 'KStG'). Under its participation exemption regime, Germany applies a 95% exemption with respect to both inter-corporate dividends and capital gains realized on the disposal of shares. Eligibility criteria are left out of consideration.

³⁵ See section 87 Italian Tax Code. Under its participation exemption regime, Italy applies a 95% exemption with respect to both inter-corporate dividends and capital gains realized on the disposal of shares. Eligibility criteria are left out of consideration.

³⁶ See Articles 116-119 of the Spanish Ley del Impuesto sobre Sociedades ('Spanish Corporate Income Tax Act' or 'Spanish CITA'). Under its participation exemption regime, Spain applies a full exemption both with respect to dividends and capital gains on shares. Eligibility criteria are left out of consideration. For some details see Adolfo J. Martín Jiménez, Spain's holding company regime, 59 Bulletin for international fiscal documentation 99 (2005), at p. 99-107.

³⁷ See Article 23-2 Japanese CTL. Japan applies a 95% exemption with respect to inter-corporate dividend receipts. Capital gains and losses are fully reflected in the Japanese corporate tax base. Eligibility criteria are left out of consideration. For details see Yoshihiro Masui, *Taxation of Foreign Subsidiaries: Japan's Tax Reform 2009/10*, 64 Bulletin for International Taxation 242 (2010), at p. 242-248. See also Tasuku Honjo, Trends in tax avoidance provisions and doctrines in Japan, 61 Bulletin for International Taxation 432 (2007), at p. 432-438.

³⁸ See Part L (Tax credits and other credits) New Zealand Income Tax Act 2007. Eligibility criteria are left out of consideration.

³⁹ See §§901– 908 (Foreign Tax Credit) US IRC. The indirect tax credit granted by the United States with respect to dividends received by US resident corporate taxpayers from foreign entities can be found in §902 IRC. Eligibility criteria are left out of consideration. In domestic scenarios a dividends received deduction applies. This will not be further discussed.

Subsidiary Directive, requiring EU Member States to adopt an exemption or indirect credit mechanism with respect to inter-company dividend distributions (accompanied with a dividend withholding tax exemption) can be mentioned in this respect as well.

Notably, mechanisms exempting proceeds from intra-group *debt* interests (such as interest expenses, interest receipts and impairment losses on debt receivables) – introduced for the purpose of removing the arbitrary differences in the corporate tax treatment of income from debt and equity financing – are quite rare, though. Examples can be found in Hungary (i.e. a 50% exemption for intra-group interest payments; this regime has been repealed as of January 1, 2010)⁴⁰ and the Netherlands (i.e. the (recently withdrawn proposal for a) ‘mandatory group interest box’ allowing for an 80% exemption for proceeds from intra-group debt arrangements)⁴¹. Instead of derecognizing intra-group debt arrangements for corporate tax purposes altogether, states commonly have interest deduction limitation regimes in place for the purpose of countering the arbitrary creation of deductible interest expenses by taxpayers attempting to reduce their local corporate tax bases and/or shifting the corporate income produced locally to low taxing jurisdictions. Thin capitalization measures (e.g. in place in Denmark, France, the Netherlands, Spain, Australia, New Zealand and Japan)⁴² and earnings-stripping rules (e.g. in place in Denmark, Germany, Italy and the United States)⁴³ can be mentioned in this respect as noteworthy examples of commonly applied correction mechanisms.

Moreover, an aggregation of the group’s business income is, for example, achieved by a variety of states on the basis of ‘profit-pooling regimes’. Examples of such regimes allowing for an aggregation of income realized by the various group companies can be found in Germany (‘Organschaft’),⁴⁴ Austria (‘Organschaft’),⁴⁵ the United Kingdom and Ireland (‘group relief regime’),⁴⁶ Portugal (‘Regime Especial de Tributação de Grupo de Sociedades’),⁴⁷ Denmark (‘national’ and ‘international joint taxation regime’),⁴⁸ Norway⁴⁹ and Finland⁵⁰ (‘group contribution regime’). As an alternative measure to profit-pooling regimes, some states allow for a tax deductible impairment of equity interests in (foreign) loss-making group companies (e.g. Spain) and/or for a deduction of losses realized at the level of a shareholding company upon the liquidation of a loss-making non-consolidated (foreign) group company (e.g. the Netherlands: the ‘liquidation losses set-off regime’).⁵¹

In addition to this, tax-neutral asset transfers between group companies are, for example, made possible in the international tax systems of the United Kingdom and Ireland (‘capital gains tax group relief’).⁵² These states allow for groups to transfer assets amongst the affiliated corporate entities on a no gain/no loss basis to the extent that the transferred assets remain within the charge to respectively United Kingdom and Irish corporation tax (i.e. the eligible assets have to remain situated within these states’ territories).

⁴⁰ For some details see Roland Felkai, *Hungary, 2010 Tax Changes*, 49 *European Taxation* 611 (2009), at p. 611-613.

⁴¹ The Dutch group interest box was proposed in ‘Consultatiedocument’, *supra* note 24 and subsequently withdrawn in ‘Sinterklaasbrief’, *supra* note 24.

⁴² The regimes can be found respectively in §11 Danish CTA, Article 212 French CGI, Article 10d Dutch CITA, Article 20 Spanish CITA, Division 820 (Thin capitalization rules) Australian IITA 1997, subpart FE (Interest apportionment on thin capitalisation) New Zealand ITA and Article 66-5 Japanese Special Taxation Measures Law (‘Japanese SMTL’).

⁴³ Respectively to be found in §11C Danish CTA, §4h of the German Einkommensteuergesetz (‘German Income Tax Code’ or ‘EStG’), articles 167 and 168 of the Italian Tax Code and §163(j) (Limitation on deduction for interest on certain indebtedness) US IRC.

⁴⁴ See §§14–19 German Corporate Tax Code. Eligibility criteria are left out of consideration.

⁴⁵ See §9 Austrian Corporate Tax Code. Eligibility criteria are left out of consideration. See for details on the functioning of the Austrian regime Wiesner/Kirchmayr/Mayr, *Gruppenbesteuerung*, LexisNexis, 2005, Wien.

⁴⁶ See Part 5 of the United Kingdom’s Corporation Tax Act 2010 (‘UK CTA’) and Section 420 of the Irish Taxes Consolidation Act 1997 (‘Irish TCA’). Eligibility criteria are left out of consideration.

⁴⁷ See Articles 69-71 of the Portuguese Imposto sobre o rendimento das pessoas colectivas (‘Portuguese Corporate Tax Act’ or ‘Portuguese IRC’). Eligibility criteria are left out of consideration.

⁴⁸ See §31 and 31A Danish CTA. Eligibility criteria are left out of consideration.

⁴⁹ See §§10-2 to 10-4 Norwegian TA. Eligibility criteria are left out of consideration.

⁵⁰ See Articles 1-8 of the Finnish Law on Intra-group Financial Transfers (Laki konserniavustuksesta verotuksessa of 21 November 1986 (‘Finnish KonsAvL’). Eligibility criteria are left out of consideration.

⁵¹ See Article 13d Dutch CITA. Eligibility criteria are left out of consideration.

⁵² See Section 171 of the United Kingdom’s Taxation of Chargeable Gains Act 1992 (‘UK TCGA’) and Section 617 Irish TCA. Eligibility criteria are left out of consideration.

These alternative correction mechanisms can all be seen as examples of approaches conceptually moving away from the separate entity approach towards a unitary business approach. On the basis of the same equity and economic efficiency arguments underlying tax consolidation regimes, these alternate measures deviate, at least to some extent, from the starting point that each group company is treated as a single taxpayer. But contrary to tax consolidation they do not fully appreciate the economic integration of the affiliated corporate entities into one single economic operator. These alternative measures only counter some specific distortive effects that the adoption of the separate entity approach entails. The separate entity approach has not been abandoned completely and the unitary business approach has not been adopted to its full extent. These alternative correction mechanisms are basically “per-element solutions” combating the symptoms that are caused by the underlying problems that ensue from taxing affiliated corporate entities on an individual basis. They can therefore be considered as examples of ‘halfway approaches’ conceptually ending up somewhere in the middle between the separate entity approach and the unitary business approach. And with that, these alternative measures may also be considered as ‘halfway solutions’ for the problems that the underlying separate entity approach causes when groups of companies are being taxed by states in today’s globalizing economy. For that reason, I leave these alternative correction mechanisms out of any further consideration in the following sections of this paper and focus on tax consolidation.

5 Tax consolidation regimes do not adequately cover the economic entity; an alternative

5.1 Reconsidering the scope of application of tax consolidation regimes

In order to remedy all distortions that ensue from applying the separate entity approach, the tax consolidation regime should not only be present within an international tax system of a state. It should also be designed in a manner that adequately covers the economic entity, i.e. the group of affiliated corporate entities that have been integrated into one economic operator. In this section, I try to demonstrate that, where present, the current tax consolidation regimes in international tax systems do not adequately cover all scenarios dealing with the corporate taxation of groups. This results in market distortions. This is true in both *domestic* and *cross-border* contexts. Consequently, the scope of application of the tax consolidation regimes typically in place in the international tax systems of states needs to be reconsidered. In the following subsections 5.2 (domestic context) and 5.3 (cross-border context), I seek to provide for a model framework for the purpose of taxing corporate groups in today’s globalizing economy.

5.2 Remedying distortive effects in a domestic context

5.2.1 Decisive influence

When determining the scope of application of a tax consolidation regime, states allowing for tax consolidation – to my impression – seek to express the power of the parent company to direct their subsidiaries’ business activities. In an attempt to identify the group or economic entity to which the respective tax consolidation regime may subsequently apply, several tax legislators have introduced requirements aiming at the volume of shares (in)directly held by the respective parent company in their subsidiaries.⁵³ The shareholding interests required for tax consolidation vary widely and range between 50+ and 100%. Italy for example, requires a shareholding interest exceeding 50% in the corporate entity’s equity capital.⁵⁴ The European Commission in its CCCTB project requires a shareholders’ interest of at least 75%.⁵⁵ The United States requires a

⁵³ See also Schön, *supra* note 13, at p. 66.

⁵⁴ See Articles 117-142 Italian Tax Code.

⁵⁵ See European Commission, Common Consolidated Corporate Tax Base Working Group (CCCTB WG), *CCCTB: possible elements of a technical outline*, CCCTB/WP057 (2007), available at: http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/ccctbwp057_en.pdf.

shareholders interest representing 80% or more of the total value and voting power of the stock of the company in which the shareholding is held.⁵⁶ The Dutch ‘fiscale-eenheidsregime’ and the French ‘régime de l’intégration fiscale’ call for shareholders interest of at least 95%.⁵⁷ In Japan, Australia and New Zealand, only wholly owned companies are eligible to form a consolidated tax group.⁵⁸

With such relatively easy to apply shareholding volume requirements, as said, it is my impression that tax legislators seek to express the power of the parent company over the organization and management of the underlying business activities of the subsidiaries in which the shares are held. Namely, the parent company’s control over the financial, economic and organizational affairs of the (sub)subsidiaries is the necessary means with which the intended economic integration of the group is shaped.⁵⁹ The property rights attached to the shares that provide the shareholder with a say in the corporate entity’s business (such as the voting rights in the shareholders meeting and/or rights of appointment and dismissal of executives) provide for the required power to direct the underlying business activities.

However, the level of shares held by the shareholder merely provides for an indication of the level of power. The power of the shareholder to steer the underlying business activities of its subsidiary does not necessarily vary directly in proportion to the volume of shares held. This is due to the fact that economic power can be manifested in numerous (legal) ways. In practice, it is for example possible to establish various types of property rights regarding the say in the shareholders meeting to various types of shares. Moreover, the say in a corporate business may even be founded on property rights other than equity interests (e.g. on contractual arrangements). Mentionable examples in this respect are group agreements (‘Beherrschungsvertrag’), or (voting) arrangements amongst shareholders and/or between shareholders and persons having other corporate (e.g. debt) interests in the business enterprise. Consequently, the size of the shareholding may – in effect – be indifferent in determining whether the respective corporate entities are economically integrated into one economic entity. At the end of the day, only the actual economic power counts. As a result of this, all shareholding volume requirements will ultimately prove to be arbitrary.⁶⁰ Therefore, in my view, a shareholding volume criterion is not suitable for identifying the group for the purpose of applying the corporate tax consolidation.

In order to bring about the economic integration into a group, the parent company needs to have some form of corporate interest that gives it in fact a *decisive influence* on the underlying business affairs of its (sub)subsidiaries (centralization of management). Only in that case may the financial, organizational and economic integration of the aggregate of corporate entities into one economic entity operating one business enterprise be present. And only in the situation where the parent company has a decisive influence may the aggregate of corporate entities be comparable with a single entity that operates its business enterprise through one or more branches. Namely, from a business economics perspective there is no difference between operating a business enterprise (directly) through a branch or (indirectly) through the branch of a controlled group company. Notably, the aforementioned may also explain the reason why the Court of Justice adopted its ‘definite influence and control’ or ‘Baars’ criterion under the freedom of establishment in its case law on fundamental freedoms in the field of direct taxation, preceding its comparison between a secondary establishment of an economic operator through a permanent establishment or a group company.⁶¹

⁵⁶ See §1504 (Consolidated Returns) US IRC.

⁵⁷ See respectively Article 15 Dutch CITA and Article 223A French CGI.

⁵⁸ See respectively Article 4-2 Japanese CTL, Section 703.15 Australian IITA 1997 and Section FM 31 New Zealand ITA.

⁵⁹ See Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Tex. L. Rev. 1301 (1996), at p. 1309, as well as OECD Investment Division, Directorate for Financial and Enterprise Affairs, *OECD Benchmark Definition of Foreign Direct Investment*, 4th Edition, OECD, Paris, 2008, at p. 15.

⁶⁰ See for a comparison F.A. Engelen, H. Vording and S. van Weeghel, *Wijziging van belastingwetten met het oog op het tegengaan van uitholling van de belastinggrondslag en het verbeteren van het fiscale vestigingsklimaat*, WFR 2008/891, in which they propose a similar criterion (a corporate interest of “more than half”, in Dutch: “belang van meer dan de helft”) for the purpose of defining an affiliate corporate entity under their proposals for a set of alternative group interest deduction limitations.

⁶¹ See Court of Justice, cases C-251/98 (Baars), C-284/06 (Burda), C-307/97 (Saint-Gobain), C-298/05 (Columbus), C-524/04 (Thin Cap GLO), C-446/04 (FII) and C-311/08 (SGI). See for a comparison also the ruling of the Dutch Supreme Court (in Dutch: Hoge Raad, hereinafter: ‘HR’) of September 26, 2008, unofficial tax reporter *Beslissingen Nederlandse Belastingrechtspraak* (‘BNB’) 2009/24. See for a comparison Court of Justice, cases C-157/05 (Holböck) and C-182/08

These observations boil down to the position that tax consolidation should, as a rule, be allowed with respect to corporate interests that provide the parent company with a decisive influence over the underlying business affairs of its subsidiaries.⁶² A decisive influence criterion may cause some legal uncertainty. This effect, however, should not be overstated. Inspiration for the interpretation of such a decisive influence criterion may, for example, be found in the control test as commonly applied under commercial accounting consolidation rules (e.g. IAS 27). Moreover, a decisive influence criterion cannot be manipulated as easily as is the case with a shareholding volume criterion. Therefore, I favor a decisive influence criterion over a shareholding criterion. Notably, in addition to this criterion, the parent company should hold its corporate interest as a capital asset (see section 5.2.2).

It should be mentioned that in scenarios where the interest does not provide the shareholder with a decisive influence on the underlying business affairs, there can necessarily be no economic integration into one economic entity. In such cases, the interest does not provide the holder with sufficient economic power to steer the underlying business affairs of its participations. In that case, the aggregate of shareholders and participation is not comparable with a group of affiliated corporate entities or a single entity that operates its business enterprise through one or more branches (or permanent establishments).⁶³⁻⁶⁴ Consequently, to that extent, tax consolidation of the aggregate of the shareholder and its participation(s) would be incorrect. In such scenarios, the single taxation of corporate income should be achieved by other means than tax consolidation.⁶⁵

5.2.2 Motive: the corporate interest granting parent decisive influence should be held as a capital asset

Under the unitary business approach, decisive influence is a necessary condition for identifying the group for corporate tax purposes. But it is an insufficient delimitation criterion as well: it does not say anything about the motive of the parent company to establish or maintain the economic integration of the group of affiliated corporate entities into one economic entity operating the business enterprise. A decisive influence merely provides for an indication of the parent company's motive. Indeed, the chances are that the definite influence providing corporate interest is held for the purpose of establishing or maintaining the economic integration into a single economic entity. However, this does not necessarily need to be the case. It is conceivable that the shareholder holds its corporate interest with another purpose. The interest may for example

(Glaxo). With respect to the concurrent application of the fundamental freedoms, see Daniel S. Smit, *The relationship between the free movement of capital and the other EC Treaty freedoms in third country relationships in the field of direct taxation: a question of exclusivity, parallelism or causality?*, 16 EC Tax Review 252 (2007).

⁶² See for a comparison IAS 27 ('Consolidated and Separate Financial Statements') on the basis of which a 'control' test has been adopted for the purpose of identifying the group of entities required to present its financial statements as those of a single economic entity (consolidated financial statements). See also Consultatiedocument, *supra* note 24, in which the Dutch State Secretary of Finance chose a decisive influence criterion in the draft proposal for a mandatory group interest box (an 80% base exemption for proceeds on intra-group debt capital arrangements). Note that the group interest proposal was withdrawn in the "Sinterklaasbrief", *supra* note 24.

⁶³ Notably, for this reason, I believe that the Court of Justice's comparison between corporate taxpayers with a domestic participation and taxpayers with a foreign participation is sound, for example in cases where the shareholder does not have a decisive influence in its participation's business affairs. Where the shareholder's interest is held as a capital asset and provides the shareholder with a decisive influence in the underlying business affairs, the comparison between the (foreign) group company and (foreign) branch (permanent establishment) seems the most appropriate to me. See for a comparison the Opinion of Advocate General (hereinafter: 'AG') Maduro in Court of Justice, case C-446/03 (Marks & Spencer II) and Bosal, *supra* note 24. Contra B.J.M Terra and P.J. Wattel, *European Tax Law*, Fifth Edition, Fiscale Studierieserie nr. 29, Kluwer Deventer, 2008, at p. 234 f.f. Wattel does not make this distinction and argues that (foreign) participations should be compared with (foreign) branches (permanent establishments) irrespective of the shareholding percentage.

⁶⁴ This may also explain why the Court of Justice applies the freedom of capital in scenarios where the shareholder's interest does not provide the shareholder with a definite influence. See FII, *supra* note 61. See for a comparison Court of Justice, case C-208/00 (Überseering) as well as Baars, *supra* note 61, Burda, *supra* note 61 (the latter two notably a contrario).

⁶⁵ Perhaps through the introduction of an allowance for corporate equity (ACE) measure in combination with a tax exemption mechanism at the level of the holder of the corporate interest (the latter may be introduced for the purpose of avoiding economic double taxation of the underlying business income earned at the level of the participation in which the interest is held).

be held for the purpose of trading it as stock. Or the interest may be held as a portfolio investment.

Accordingly, the motive of the holder of the corporate interest should be taken into consideration when determining the scope of application of the respective tax consolidation regime. This requires an answer to the factual question of the intention of the taxpayer employing the respective interest. This intention may be objectified through a functional and factual analysis of the position that the property right fulfils in the taxpayer's property.⁶⁶ In this respect, one can distinguish between property rights that are held as a current floating asset (portfolio investment, trading stock), or as a capital asset. One may speak of a portfolio investment in the event that a taxpayer holds a property right for the purpose of earning a yield that may be expected from normal portfolio asset management.⁶⁷ In return for a fee, the taxpayer makes its property available for the benefit of the economic activities of another (i.e. third) party. One may speak of trading stock in the event that a taxpayer holds a property right for the purpose of trading it with third parties in return for a selling price. One may speak of a capital asset in the event that a taxpayer holds a property right for the purpose of employing it for the benefit of its business enterprise on a continuing basis. Where property rights are held as trading stock or as a capital asset, the taxpayer makes its property available for the benefit of its own business activities.⁶⁸ The difference between trading stock and a capital asset is that property held as trading stock lasts for one production process, where property held as a capital asset lasts for multiple production processes. In the event that the commercially exploited property right is a corporate (shareholding) interest, the aforementioned *mutatis mutandis*, in my view, holds true as well. I do not see why the nature of the respective property (tangible, intangible, monetary) should make a difference in qualifying it as a portfolio investment, trading stock, or capital asset.

Tax consolidation should only be allowed in scenarios where the parent company holds its corporate interest – which grants it decisive influence – for the purpose of employing it for the benefit of the underlying business enterprise on a continuing basis (i.e. the property rights last for more than one production process). The unitary business approach requires that the shareholding interest reflects the integration of the group of affiliate corporate entities into one economic entity, operating a business enterprise. This requirement is only met in the event that the interest is held as a capital asset. Only then is the corporate interest employed on a continuing basis for the benefit of the business enterprise that is operated by the economic entity.

The unitary business approach cannot be reconciled with a consolidation of corporate interests that are held as a portfolio investment or as trading stock. To that extent, there is no presence of a single economic entity operating a business enterprise. With respect to corporate interests held as a portfolio investment or trading stock, the function of the interests as security or merchandise has primary meaning. The underlying property or (business) activities of the corporate entity in which the interest is held is merely of secondary importance to the holder of the interest. Consequently, the tax consolidation of portfolio or trading stock interests should not be possible. The single taxation of corporate income should then be achieved through alternative means.⁶⁹ Notably, the nature of the underlying property should not be of pivotal importance for the purpose of identifying the intention (motive) of the taxpayer employing its corporate interest. It merely provides for an indication of the taxpayer's intention as the nature of the underlying property influences the interest's liquidity.

Not many states have adopted a motive test in their international tax system for the purpose of defining the group which is eligible to apply the tax consolidation regime. At least, I did not come across one in my search for it. Why is that? I would say basically because a motive test may be considered administratively inconvenient to apply in practice as the tax authorities will have to decide on the taxpayers' intention. Moreover, the adoption of a motive test in the tax

⁶⁶ See for a comparison, OECD Report on the Attribution of Profits to Permanent Establishments, OECD (Paris: 2008).

⁶⁷ This approach has for example been taken by the Dutch Supreme Court. See HR September 27, 1995, BNB 1996/18, HR June 23, 1999, BNB 1999/294 and HR October 21, 2005, BNB 2006/126. See also HR November 7, 1973, BNB 1974/2, HR November 8, 1989, BNB 1990/73, HR 5 November 1997, BNB 1998/37-38, HR 26 August 1998, BNB 1998/373, HR 10 November 1999, BNB 2001/140 and HR 14 March 2001, BNB 2001/210. See for some details, Geert T.W. Janssen & Maarten F. de Wilde, *supra* note 27, at section 3.

⁶⁸ See for a comparison Avi-Yonah, *supra* note 59, at p. 1305-1310.

⁶⁹ See *supra* note 65.

consolidation regime is not always relevant for states when things are seen from the perspective of securing corporate tax revenue. When there is no risk of losing tax revenue, there is no practical necessity to exclude majority interests in corporate entities that are held as trading stock or as a portfolio investment from the tax consolidation. This is true in the event that the company in which the interest is held is, in effect, subject to corporate tax in the respective taxing jurisdiction. The consolidation of such an interest for corporate tax purposes does not lead to a loss of tax revenue. Indeed, the taxable unit does not correspond with the economic entity. But why bother?

Accordingly, one may expect the presence of a motive test in a tax consolidation regime when the risk of losing tax revenue appears. This may, for example, be the case when a corporate interest is held in an entity that is exempt from corporate tax. Notably, it needs to be said first that there may be a valid reason to exempt (corporate entities conducting) certain activities from corporate taxation. In this respect, one may think of charitable institutions and/or other entities conducting activities serving the public benefit without having the objective of yielding a business profit. Such entities may not be taxed on the ground that they do not operate a business enterprise. Moreover, one may think of portfolio investment institutions. Some states, such as the Netherlands, Luxembourg and Ireland, exempt such institutions from corporate tax.⁷⁰ Conceptually, there is nothing wrong with that. From a tax perspective, portfolio investment institutions conceptually do not have an independent stance. Investment institution regimes exist solely to meet the societal need for the availability of benefits of scale and the spreading of risks to small-time portfolio investors by means of an intermediary collective investment vehicle. The imposition of a corporate tax at the level of the intermediary would nullify this aim as the tax cost at the level of the underlying portfolio investor holding its investment through the intermediary would increase in comparison with the tax cost for portfolio investors holding their investments directly. For the purpose of attaining tax neutrality between *directly* held portfolio investments and portfolio investments that are *indirectly* held, i.e. through an intermediary, investment institutions should be considered as ‘not present’ for corporate tax purposes. Technically, this may be arranged by considering the institution to be transparent (‘transparence fiscale’), exempting the taxable unit from tax (‘subject exemption’), exempting the proceeds from tax (‘base exemption’), or adopting a 0% tax rate. Indeed, the adoption of such exemption regimes may result in some undesired side-effects (arbitrage). The tax consolidation of exempt and taxed entities for corporate tax purposes would entail that taxable profits could be set off against exempt losses with the consequence of the taxable income remaining untaxed. Consequently, the risk of losing tax revenue would become apparent. This may trigger taxpayers to utilize tax avoidance arrangements.

Typically, however, rather than applying a motive test, states that have adopted tax exemption regimes commonly counter the aforementioned arbitrage effects by including provisions stipulating that only (fully) taxable entities are eligible to be part of a consolidated tax group. The Netherlands, for example, has adopted such a requirement on the basis of which tax exempt, for example, portfolio investment institutions cannot form a consolidated tax group with regularly taxed entities.⁷¹ Applying the requirement that exempt entities are not eligible to become part of the consolidated tax group is administratively convenient. Moreover, an interest held in an exempt portfolio investment institution indicates that the holder’s intention is to hold the interest as a portfolio investment rather than as a capital asset. Accordingly, the taxpayer’s motive appears in an implicit manner. However, this approach is conceptually unsound as it does not cover all scenarios in which a unitary business is absent. Namely, the adoption of such a requirement entails that corporate entities in which the interest is directly held (i.e. without an investment institution as an intermediary), yet with the intention of holding it as a portfolio investment asset, would become eligible to be part of the consolidated tax group. Substantially, however, a corporate interest does not necessarily have to be held through a portfolio investment

⁷⁰ The investment institutions in these countries eligible to the specific tax treatment are referred to as the ‘Vrijgestelde beleggingsinstelling’ and the ‘Fiscale beleggingsinstelling’ (the Netherlands), the ‘Société d’Investissement à Capital Variable’ and the ‘Fonds Commun de Placement’ (Luxembourg) and the ‘Common Contractual Fund’ (Ireland). These regimes are not further discussed.

⁷¹ See Article 15 Dutch CITA. Under Dutch tax law entities subject to a special tax regime (e.g. exempt from tax, or subject to a 0% tax rate) are ineligible to be part of the consolidated tax group.

institution in order to qualify as a portfolio investment. Corporate interests held as a portfolio investment may very well be held directly rather than through an intermediate portfolio investment institution. Consequently, when interests held as a portfolio investment or trading stock are consolidated, the taxable unit does not correspond with the economic entity. Market distortions may occur as a consequence of this. My impression is that states take this effect for granted in domestic scenarios, as it will not be likely that tax revenue will diminish due to this. From the perspective of securing tax revenue, it suffices to adopt a rule providing that exempt entities are not eligible to become part of the consolidated tax group. Yet, the unitary business approach requires that each shareholders interest held as a portfolio investment (or as stock) should be excluded from tax consolidation. Not only when the interest is indirectly held via a portfolio investment institution. Accordingly, only a motive test would provide a conceptually sound outcome in this respect.⁷²

Furthermore, tax consolidation regimes generally do not apply in cross-border scenarios (see also section 5.3). Cross-border tax consolidation is a rare phenomenon. Consequently, if the eligibility to form a consolidated tax group is kept limited to (the) domestic (part of) groups, there is no practical need for introducing a motive test. This is true since no risk of losing tax revenue emerges as the tax consolidation only applies in domestic scenarios. Evidently, this explains the common absence of motive tests in tax consolidation regimes. Notably, the distortive effects of disallowing cross-border tax consolidation are discussed hereunder in section 5.3.

Despite their absence in tax consolidation regimes, motive tests in themselves are not uncommon, though. They do exist. In practice, motive tests are found with respect to the application of the alternative correction mechanisms referred to in section 4, whose scope of application – contrary to tax consolidation regimes – in effect typically does extend beyond the domestic tax borders. And in those cross-border scenarios, the possibility of tax avoidance emerges. In practice, this reality has often been countered by states on the basis of motive tests adopted within the context of their alternative *ad hoc* countermeasures. In this respect, one may think of the motive tests commonly applied with regard to participation exemption and indirect credit mechanisms, as well as interest deduction limitation and anti-deferral (controlled foreign company or ‘CFC’) mechanisms. These mechanisms basically seek to (a) achieve single taxation of active (i.e. business) income in the jurisdiction in which the income has been produced geographically and (b) counter the sheltering of passive (i.e. portfolio investment) income in, or the arbitrary shifting of active income to, low-taxing jurisdictions. For the purpose of attaining these objectives, many states subject the application of these mechanisms (amongst others) to motive tests. For example, the Netherlands denies the application of the participation exemption and switches over to an indirect credit mechanism with respect to proceeds from equity interests in (foreign) low-taxed companies that are held as a portfolio investment.⁷³ Similar ‘switch-overs’ from exemption to credit can be found in the Austrian and German international tax systems.⁷⁴ Moreover, anti-deferral legislation adopting ‘look through’ or ‘deeming dividend receipts’ approaches typically applies in scenarios where the controlling corporate interests in the (foreign) low-taxed corporate entities are held as (passive) portfolio investments. Anti-deferral regimes can, for example, be found in the tax legislation of the United Kingdom, the United States, Denmark, Finland, Norway, Germany, Italy, Spain, Australia, New Zealand and Japan.⁷⁵

By adopting motive tests with respect to the application of these alternative correction mechanisms, the respective tax legislators – to my impression – seek to express the intention of the parent company to establish or maintain the economic integration of the group of affiliate

⁷² Notably, the same would hold true for interests in exempt charitable institutions. The tax consolidation of such an interest would be disallowed under a motive test as such an interest would not be held as a capital asset.

⁷³ See Article 13, ninth indent, Dutch CITA. See for some details, Geert T.W. Janssen & Maarten F. de Wilde, *supra* note 27, at sections 1 and 3.

⁷⁴ See respectively §10(3) Austrian Corporate Tax Code and e.g. §20 German AStG.

⁷⁵ See respectively Chapter IV of Part XVII of the United Kingdom’s Income and Corporation Taxes Act 1988 (‘UK ICTA’), Subpart F (Controlled Foreign Corporations) US IRC, §32 Danish CTA, §1-8 of the Finnish Act on the Taxation of Shareholders in Controlled Foreign Companies (1217/1994), §§10-60 to 10-68 of the Norwegian TA, §§7-14 of the German Außensteuergesetz (‘German Foreign Transaction Tax Law’, or ‘German AStG’), Articles 167 and 168 Italian Tax Code, Article 121 Spanish CITA, Part X (Attribution of income in respect of controlled foreign companies) Australian IITA 1936, Subpart EX (Controlled foreign company and foreign investment fund rules) New Zealand ITA and Articles 66-6 to 66-9 Japanese SMTL. I understand that Australia is currently in the process of reforming their CFC legislation.

corporate entities into one business enterprise. When the taxpayers' actual intention differs from the required motive of establishing or maintaining a business enterprise, the application of the correction-mechanism is triggered (e.g. interest deduction limitation, anti-deferral) or denied (e.g. participation exemption is disallowed and a credit mechanism is applied alternatively). Obviously, the required motive is absent in the event that it is intended to shift income to low-tax jurisdictions. The same is true in the event that the corporate interest is held as a portfolio investment asset or for the purpose of trading it as stock.

The aforementioned observations boil down to the position that a functional criterion should be introduced in the respective tax consolidation regime in order to respect the unitary business approach. This criterion should apply in addition to the decisive influence criterion mentioned in section 5.2.1 (this holds true in both purely domestic and cross-border scenarios). For this purpose, one may think of introducing a 'held as capital asset' criterion in the respective tax consolidation regime of the taxing state. An alternative would be to adopt a 'not held as trading stock' criterion⁷⁶ and a 'not held as portfolio investment' criterion.⁷⁷ Moreover, this functional approach may, for example, be arranged as a tool to distribute the burden of proof between the taxpayer and the tax authorities.⁷⁸

In order to avoid arbitrary outcomes ('cherry-picking'), the tax consolidation should apply *in jure* rather than on request (i.e. a mandatory 'all-in' approach).⁷⁹ The application of the tax consolidation regime may be attended by a declaratory resolution issued by the respective competent tax authorities (as is currently the case with the *in jure* 'fiscal unity' for VAT purposes within the European Union).

Excluding tax consolidation with respect to shareholders' interests held as trading stock or as a portfolio investment entails that the separate entity approach would be applied in those circumstances. Market distortions would be the consequence: economic double taxation on similar types of business income (e.g. portfolio investment yields). Value mutations of the underlying property may lead to taxable income on both the level of the corporate entity (taxpayer a) holding the property and the corporate entity (taxpayer b) holding the shareholders' interest, i.e. cascading tax problems. Solutions for the distortive effects of the separate entity approach with respect to income from shareholders' interests held as stock or as portfolio investments in my view, should nevertheless be sought outside a tax consolidation regime.⁸⁰

Worthy to note is that the adoption of a functional approach through a 'held as capital asset' criterion in addition to the aforementioned 'decisive influence criterion' may also be of some use in answering the question of which fundamental freedom should be applicable in scenarios falling within the confines of the Treaty on the Functioning of the European Union ('TFEU') where the shareholding interest provides the shareholder with a definite influence on the underlying business activities. The Court of Justice does not seem to adopt a consistent approach in deciding on the applicable freedom when it concerns majority shareholdings. In the *Burda* and *Thin Cap GLO* cases, the Court of Justice, for example, considers the freedom of establishment to be exclusively applicable in scenarios where the 'definitive influence test' as first established in the *Baars* case has in fact been met (a factual approach).⁸¹ In the *Holböck* and *Glaxo Wellcome* cases, the Court of Justice nevertheless considers the freedom of capital to be applicable in scenarios where the shareholder in fact has a definite influence on the underlying business activities, thereby taking into account the object and purpose of the respective domestic EU Member State's legislation that is subject to the Court of Justice's scrutiny (an object and

⁷⁶ See for a comparison IFRS 5 ('Non-Current Assets Held For Sale') under which a controlled entity that meets the IFRS 5 criteria as an asset held for sale is separately accounted for under that Standard rather than under IAS 27.

⁷⁷ A 'not held as a portfolio investment' criterion has, for example, been reintroduced in the Dutch participation exemption regime as of January 1, 2010, for the purpose of identifying shareholdings held as portfolio investments. See Article 13(9) Dutch CITA.

⁷⁸ See for a comparison S.A.W.J. Strik, *De voorgelegde regeling voor beleggingsdeelnemingen: een verbetering, maar verduidelijkend gewenst!*, WFR 2009/969, at section 5.1.

⁷⁹ See for a comparison European Commission (20/11/2006), *CCCTB: Progress to Date and Future Plans for the CCCTB*, CCCTB/WP046 available at: http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/CCCTBWP46_progress_future_en.pdf.

⁸⁰ See *supra* note 65.

⁸¹ Respectively *Burda*, *supra* note 61, *Thin Cap GLO*, *supra* note 61, and *Baars*, *supra* note 61.

purpose approach).⁸² Unfortunately, the Court of Justice does not explain its underlying reasons for taking these apparently diverging approaches. The Court of Justice could adopt the aforementioned functional approach as an alternative. If the intention of the shareholder were to be taken into consideration, the freedom of establishment could apply exclusively in scenarios where the shareholder has (a) a decisive influence and (b) holds its corporate interest as a capital asset. In cases where the shareholder does not hold its interest with this intention, there could be room for applying the freedom of capital (e.g. when the shares are held as a portfolio investment), or services (e.g. when the shares are held as trading stock).

5.3 Remedying distortive effects in a cross-border context; subject group to unlimited tax liability and provide double tax relief through credit for domestic tax attributable to foreign income

As already briefly touched upon in section 5.2.2, typically, states do not allow for cross-border tax consolidation. To my knowledge, only France ('regime du bénéfice mondial consolidé')⁸³ and Italy ('consolidato mondiale')⁸⁴ principally allow for full cross-border tax consolidation. If available, states typically only allow for consolidated tax grouping to the extent that the string of group companies qualify as resident taxpayers in the respective taxing state (i.e. foreign group companies are ineligible to become part of the consolidated tax group). This is for example the case in Australia,⁸⁵ New Zealand,⁸⁶ Japan⁸⁷ and the United States⁸⁸ (see scenarios 1 to 3 hereunder). Or tax consolidation applies with respect to foreign group companies, but only to the extent that (a) these foreign companies are subject to domestic corporate tax due to the presence of a permanent establishment in the respective taxing jurisdiction applying the consolidation regime (b) the shareholders' interest in the underlying group company is attributable to that permanent establishment on the basis of a functional and factual analysis. Examples of the latter approach may be found in the international tax systems of Luxembourg⁸⁹ and the Netherlands⁹⁰ (see scenarios 4 to 6 hereunder).⁹¹ Notably, this is true, save for the exceptions of France and Italy which, as said, have adopted optional ('all-in' or 'all-out') worldwide tax consolidation regimes in their international tax systems. However, the formation of cross-border consolidated tax groups under the French and Italian tax consolidation regimes is only possible to the extent that the ultimate parent company is respectively a French or Italian resident taxpayer.⁹² France and Italy do not allow non-resident parent companies to be part of the cross-border consolidated tax group. Where states only allow for the formation of consolidated tax groups to the extent that the string of group companies qualifies as resident taxpayers in the respective taxing state, the following scenarios are not available:

1. the tax consolidation of resident taxpayer parent companies with resident taxpayer sub-subsidiaries (group companies) in the event that the intermediate shareholding company has its tax residency outside the respective taxing state's territory;

⁸² Respectively Holböck, *supra* note 61, and Glaxo Wellcome, *supra* note 61. See for a comparison Sigrd Hemels, Joost Rompen, Patrick Smet, Isabelle De Waele, Steffan Adefeldt, Gottfried Breuninger, Markus Ernst, Viviane Carpentier, Siamak Mostafavi, *Freedom of Establishment or Free Movement of Capital: Is there an Order of Priority? Conflicting Visions of National Courts and the ECJ*, 19 EC Tax Review 19 (2010), at p. 31. Hemels et al, substantially, recognize the Court of Justice's ambivalent approach as well.

⁸³ See Article 209 quinquies French CGI. France has adopted an optional 'all-in' or 'all-out' approach.

⁸⁴ See Articles 130-142 Italian Tax Code. Italy applies an optional 'all-in' or 'all-out' approach as well.

⁸⁵ See Divisions 703 (Consolidated groups and their members) and 719 (MEC groups) Australian IITA.

⁸⁶ See Section FM 31 New Zealand ITA.

⁸⁷ See Article 4-2 Japanese CTL.

⁸⁸ See §1504 (Consolidated Returns) US IRC.

⁸⁹ See Article 164bis Luxembourg ITL.

⁹⁰ See Article 15 Dutch CITA.

⁹¹ Germany adopts similar requirements with respect to the application of its 'Organschaft' (profit pooling) regime. See §18 German Corporate Tax Code. Accordingly, the German 'Organschaft' does not allow for cross-border profit pooling (contrary to its Austrian counterpart: see *supra* note 96).

⁹² See respectively Article 209 quinquies French CGI and Articles 130-142 Italian Tax Code.

2. the tax consolidation of same-tier resident taxpayer group companies ('sister companies') in the event that their mutual (ultimate) parent company has its tax residence outside the respective taxing state's territory; and;
3. the tax consolidation of a parent company or subsidiary having its tax residence outside the respective taxing state's territory (foreign group companies).

Where states enable tax consolidation with respect to foreign group companies, but only to the extent that these companies are subject to corporate tax in the respective taxing jurisdiction applying the consolidation regime, the following scenarios are not available:

4. the tax consolidation of resident taxpayer parent companies with resident taxpayer sub-subsidiaries (group companies) in the event that the intermediate shareholding company:
 - o has its tax residence outside the respective taxing state's territory, and;
 - o does not conduct business in the taxing state through a permanent establishment to which the shareholders' interest in the underlying resident taxpayer group company is attributable;
5. the tax consolidation of same-tier resident taxpayer group companies with their mutual (ultimate) parent company in the event that this parent company:
 - o has its tax residence outside the respective taxing state's territory; and
 - o does not conduct business in the taxing state through a permanent establishment to which the shareholders' interest in the underlying resident taxpayer group companies (sister companies) is attributable;
6. the tax consolidation of a parent company or subsidiary having its tax residence outside the respective taxing state's territory (foreign group companies) without a permanent establishment situated within the taxing state's territory to which the shareholders' interest is attributable.

In the aforementioned six cross-border scenarios, tax consolidation is not allowed with respect to the group's foreign source business income to the extent that the group of affiliated corporate entities conducts its business activities abroad through foreign tax resident group companies. Notably, even Italy and France, which do allow for cross-border consolidated tax grouping, limit the application of their tax consolidation regimes to foreign subsidiaries (rather than also including foreign parent companies). As said, foreign parent companies are not eligible to be part of the French or Italian consolidated tax group. By disallowing the formation of consolidated tax groups in these cross-border scenarios, states do not adopt the unitary business approach with respect to the cross-border (and/or intra-EU) business activities of groups of affiliated corporate entities. Instead, the separate entity approach is maintained in those cases.

Substantially, by disallowing the formation of consolidated cross-border tax groups, the group's foreign source business income is excluded from the domestic corporate tax base substantially through a 'base exemption for foreign income'.⁹³ Under a base exemption, the market distortions imposed under the separate entity approach are maintained.⁹⁴ The aggregation of business losses and profits realized by the respective group companies is not allowed. This results in (liquidity) disadvantages for the internationally active group in comparison with purely domestic scenarios where tax consolidation is possible.⁹⁵ A noteworthy exception in this respect is Denmark, whose international tax system (upon request) allows for the pooling of income realized by domestic and foreign group companies (both foreign parents as well as subsidiaries; the all-in approach) under its 'international joint taxation' regime.⁹⁶ I understand that a 'claw-back'

⁹³ Corporate entities having their tax residence outside a taxing jurisdiction and without having a permanent establishment situated within that respective taxing jurisdiction's territory are excluded from corporate taxation. Corporate entities having their tax residence outside a taxing jurisdiction, but nevertheless having a permanent establishment situated within that respective taxing jurisdiction's territory are excluded from corporate taxation to the extent that the business income has been earned outside that respective taxing jurisdiction's territory (or, at least, to the extent that the income cannot be attributed to that permanent establishment).

⁹⁴ This is true with respect to all (substantial) applications of the base exemption methodology (including the application of a base exemption for business income realized abroad through a permanent establishment or head office as well as the application of a base exemption to business income realized abroad through a non-resident group company).

⁹⁵ See also De Wilde *supra* note 2, at section 8 and De Wilde *supra* note 14, at section 3.

⁹⁶ See §31A Danish CTA. It should be noted that Austria also allows for cross-border profit pooling under its 'Organschaft' (profit pooling) regime laid down in §9 Austrian Corporate Tax Code. Yet, contrary to its Danish counterpart, cross-border

mechanism applies under the Danish international tax system for the purpose of ensuring single taxation.⁹⁷ In addition to the typically disallowed cross-border profit pooling, intra-group transactions are recognized for corporate tax purposes.⁹⁸ This, for example, leads to the imposition of exit taxes on cross-border intra-group asset transfers. (Liquidity) disadvantages are the result of that.

In the aforementioned six cross-border scenarios, the single taxation of the group's business income is not achieved in an equitable and tax-efficient manner.⁹⁹ The limited scope of application of the respective states' tax consolidation regimes in scenarios 1 to 6 entails that MNEs that are economically present within a taxing state and taxed on that basis accordingly are subject to a different corporate tax burden in that state in comparison with purely domestic scenarios. The different domestic burden imposed is dependant on the question whether:

- the place of residence of the respective group companies lies within or outside the respective taxing state's territory, and/or;
- the business activities of the group are solely performed within the respective taxing state's territory, or spread across various states.

Despite the reality that groups of affiliated companies operating a business enterprise in today's emerging global market are comparable from a business economics perspective, irrespective of whether the business activities are performed in a cross-border or purely domestic context,¹⁰⁰ they are nevertheless subject to a different domestic corporate tax burden. By doing so, the tax legislation in the respective taxing states distorts the decision of groups of companies as to whether or not to conduct business activities in a cross-border context. Cross-border business activities are made less attractive in comparison with their non-cross-border equivalents. This is unfair. An alternative is required.

Fairness within the international tax system of a state calls for consistently adopting the unitary business approach and with that for tax consolidation in both domestic and cross-border scenarios ('global consolidation'). Following French and Italian precedents, states should enable multinational groups of companies to form cross-border consolidated tax groups. But contrary to the French and Italian regimes that only allow for the consolidation of foreign subsidiaries, tax consolidation should be applied in jure with respect to all group companies ('all-in-approach') irrespective of their place of tax residence, i.e. including foreign parent companies. As argued in section 5.2, the tax consolidation of subsidiaries should occur to the extent that the ultimate parent company has a decisive influence on the underlying business activities (see section 5.2.1) and holds its corporate interest as a capital asset (see section 5.2.2). The subsidiaries included in the consolidation would become transparent for corporate tax purposes in a manner comparable to the transparency of affiliated entities that achieved branch status under the U.S.'s 'check the box' regulations. Full pass-through corporate taxation of both domestic and foreign group companies would become the default approach rather than the exception to the rule.¹⁰¹

profit pooling is only enabled under the Austrian 'Organschaft' to the extent that it concerns profits realized abroad through foreign subsidiaries (Austria enables an optional profit pooling on a per subsidiary basis). Profits realized abroad by foreign parent companies are excluded from the Austrian profit pooling regime. As with the Danish system, the Austrian regime contains a 'claw-back mechanism' implemented for the purpose of ensuring single taxation: the foreign losses are recaptured if these losses are available to be utilized abroad by way of a local loss carry-back or -forward.

⁹⁷ See §31A Danish CTA.

⁹⁸ Again, it should be noted that this holds true with the exception of proceeds from shareholding interests in group companies, with respect to which a participation exemption or indirect credit mechanism applies in conjunction with the application of a dividend withholding tax exemption (or a 0% rate on dividend distributions).

⁹⁹ Contra Court of Justice, case C-337/08 (X Holding). The Court of Justice does not recognize an infringement of the freedom of establishment regarding the Dutch tax consolidation regime not allowing tax consolidation as in scenarios 4 to 6. See De Wilde *supra* note 14.

¹⁰⁰ Contra X Holding, *supra* note 99. See for a comparison De Wilde, *supra* note 14.

¹⁰¹ Contra Schön, *supra* note 5, at p. 67 f.f. and Schön, *supra* note 13, at p. 68. Schön takes the position that a full pass-through taxation of foreign subsidiaries does not make sense. I respectfully disagree with this. As a first argument to denounce pass-through taxation, Schön refers to the universal acceptance of the separate entity approach. I, however, do not see why the separate entity approach would have to be accepted merely because of its current status quo in international taxation. The separate entity approach is just one of the (many) problems facing us today when taxing MNEs. Referring to its common application in practice for the purpose of denouncing an alternative does not seem to make sense. That is throwing in the towel. In my view, legal instruments should not be considered valid or right by simply pointing at their existence. Legal systems, including international tax systems, are man-made, intellectual achievements. They can be shaped, formed and altered to our wishes. If one establishes a rule that does not function properly, I would

Following the building blocks for an internally equitable and capital neutral international tax system which I advocated earlier in Intertax,¹⁰² the group should be subject to an unlimited corporate tax liability in each taxing jurisdiction in which it exceeds a minimum threshold of economic activity, i.e. in each jurisdiction in which it operates a business. The methodology which is commonly operated to identify that threshold is deemed not to encroach upon the origin principle (see the third hypothesis in section 4). The currently generally applied source concepts permanent establishment and place of effective management are deemed to operate in accordance with economic reality (but see section 6.3).¹⁰³ The ultimate parent company would accordingly be subject to corporate tax as soon as the group, irrespective of the place of its corporate seat, operates its commercial activities within a taxing jurisdiction through a fixed place of business. As the respective taxing state would subject the parent company to unlimited tax liability it would tax the group on its worldwide business income earned. As a result of this, corporate seats would cease to be of any relevance for the purpose of levying corporate tax.

To appreciate the sovereignty of states in the field of direct taxation and to acknowledge the single tax principle as well, the adoption of a fair double tax relief mechanism would be required with respect to the MNE's foreign business income items. In order to achieve internal equity and capital neutrality regarding cross-border business activities in comparison with purely domestic business activities, the double tax relief method should be the (per country) 'credit for domestic tax that is attributable to the foreign income' in conjunction with the 'recapture of foreign losses methodology' and the 'carry forward of foreign profits methodology'. This double tax relief mechanism is currently applied in the Netherlands with respect to a resident taxpayer's proceeds from a business operated through a foreign permanent establishment and is commonly referred to as a 'tax exemption'.¹⁰⁴ Application of this double tax relief mechanism renders irrelevant the question of whether the taxable unit's business income has been generated across various taxing jurisdictions. The domestic corporate tax burden imposed would not alter upon a change of taxing jurisdiction. I substantiated this thesis and described the double tax relief mechanism in some detail in an earlier publication.¹⁰⁵ Notably, the methodology commonly operated to mutually divide the corporate tax base between states is deemed not to encroach on the origin principle (see the third hypothesis in section 4). The commonly applied profit allocation (i.e. transfer pricing) methodology is considered to operate in accordance with economic reality (but see section 6.3).¹⁰⁶ Business profits would accordingly be geographically allocated to taxing jurisdictions on

say that the response should be to start thinking of an alternative that does work. Moreover, as a second argument, Schön refers to the gap that would otherwise emerge between domestic group companies (taxation on an individual basis) and foreign group companies (pass-through taxation). This gap would become too striking. As I see it, however, one should treat domestic and cross-border scenarios alike. Provided that this would be achieved, no gap would emerge in the first place as the pass-through taxation mechanism would be applied to both domestic and foreign group companies.

¹⁰² See De Wilde, *supra* note 2, at sections 7 and 9. See also De Wilde, *supra* note 14, at section 2.

¹⁰³ The question of whether these concepts adequately capture the economic presence of the economic operator and its business profits is left out of consideration here as I deemed them to operate adequately under the third hypothesis referred to in section 4 (see also section 6.3). In this respect, see Schön *supra* note 5, at section 1, Dale Pinto, *The Need to Reconceptualize the Permanent Establishment Threshold*, 60 Bulletin for International Taxation 266 (2006), at p. 266-279, Arthur J. Cockfield, *The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles*, 56 Bulletin for International Taxation 606 (2002), at p. 606-619 and Michael J. Graetz, *The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies*, 54 Tax L. Rev 261 (2001), at p. 261-336.

¹⁰⁴ Notably, there is some practical experience with the technical consequences of applying a cross-border tax consolidation, for example in the Netherlands as the former (pre 2003) tax consolidation regime – to a certain extent – allowed for the consolidation of non-Dutch tax resident companies (consolidation of non-Dutch resident companies was possible, subject to the provision that these companies were incorporated under Dutch company law). In this respect, reference can be made to HR March 16 1994, BNB 1994/191, HR June 29, 1988, BNB 1988/331 and HR November 13, 1996, BNB 1998/47. Possible technical double-tax treaty complications are left out of consideration. In this respect, reference can be made to Michael Lang, *CFC Regulations and Double Taxation Treaties*, 57 Bulletin for International Taxation 51 (2003), at p. 51-58. See for a comparison C. van Raad, *Internationale aspecten van het herziene regime inzake de fiscale eenheid*, WFR 2000/85. In scenarios falling within the scope of application of the TFEU, double tax treaty implications seem irrelevant. The reason for this is that these scenarios (i.e. intra-EU establishments) involve EU Member States whose international tax systems (i.e. both their domestic tax legislation and their double tax treaty network) are subordinate to supranational EU law.

¹⁰⁵ See De Wilde, *supra* note 2, at sections 7 and 9, as well as De Wilde *supra* note 14, at section 3.

¹⁰⁶ See OECD *supra* note 66. The question of whether the arm's length principle provides an adequate methodology to allocate business income in a cross-border context is left out of consideration here as I deemed them to operate

the basis of the “two-step analysis” as developed by the OECD in its report on the attribution of profits to permanent establishments. Finally, as a complementary measure, withholding taxation on intra-group dividend distributions, as well as intra-group interest and intra-group royalty payments should be abolished as well (i.e. to secure single taxation).

In cross-border scenarios where neither a double tax convention nor the TEU applies, the application of the double tax relief methodology may be preceded by a ‘subject to a reasonable tax clause’ in combination with a switch-over to the commonly applied ordinary credit for foreign tax method. Such a correction mechanism could be based on anti-tax avoidance considerations as it would disallow the sheltering of (passive) income in low-taxing jurisdictions. The subject-to-tax-clause may be complemented with a rule placing the burden of proof at the level of the group/taxpayer invoking the double tax relief. As an alternative to a subject-to-tax clause, one may think of applying the ‘switch-over’ to the credit method on the basis of a motive test, set up in accordance with the Court of Justice’s reasoning in the Cadbury Schweppes and Part Service cases.¹⁰⁷ In that event, the switch-over to the (direct) credit mechanism would be applied with respect to wholly artificial arrangements set up with the intention of escaping the domestic corporate tax normally payable.

6 Consequences

6.1 Weighing the pros and cons: the pros

Unlimited corporate tax liability for groups economically present within the respective taxing jurisdiction in conjunction with a ‘credit for domestic tax that is attributable to the foreign income’ would entail fairness within the corporate tax system of a state. The tax treatment of corporate groups and single corporate entities would be brought up to the exact same level in both cross-border and non-cross-border (i.e. purely domestic) scenarios. It would remove all distortions that are currently caused by the commonly adopted approach to treating each group company as a single taxable unit (resident or non-resident taxpayer) for corporate tax purposes. Corporate tax burden and revenue levels would not be influenced by the MNEs’ legal structuring or the question of whether business is conducted in a domestic or cross-border context. This requires some clarification.

First, an international tax system as proposed would not lead to any obstacles imposed with respect to the corporate taxation of MNEs.¹⁰⁸ The domestic corporate tax levied on the group’s business income would be the same under all circumstances. The corporate seat of the group would not entail any differences in corporate tax treatment (no discriminations). Moreover, it would not make any difference whether the group realizes its business profits solely within one taxing jurisdiction or spread across various states (no jurisdiction entry/exit restrictions). The way in which capital movements are directed (inbound or outbound) would have no influence whatsoever on the tax burden in the respective taxing state (internal equity / capital neutrality). The aggregation of losses and profits realized by the various (foreign) affiliates of the same group within the tax year (horizontal loss compensation) would be enabled. Liquidity disadvantages would not come up as legal transactions between the affiliates (intra-group transactions) would be treated for corporate tax purposes in the same manner as the economically equivalent internal dealings between the branches of a single entity. Cross-border asset transfers would not lead to the immediate imposition of exit taxes on hidden reserves. Foreign source income items would be kept outside the domestic tax base both in an effective and economically efficient manner. In scenarios falling within the scope of the TFEU, such an international tax system would be in full

adequately under the third hypothesis referred to in section 4 (see also section 6.3). For that purpose, reference can be made to Michael Kobetsky, *The Case for Unitary Taxation of International Enterprises*, 62 Bulletin for International Taxation 201 (2008), at p. 201-215; Walter Hellerstein, *The Case for Formulary Apportionment*, 12 International Transfer Pricing Journal 103 (2005), at p. 103-111 and Kerrie Sadiq, *Unitary Taxation – The Case for Global Formulary Apportionment*, 55 Bulletin for International Taxation 275 (2001), at p. 275-286. Contra OECD, *Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines*, 9th September 2009 – 9th January 2010, OECD Centre for Tax Policy and Administration, at p. 9-13.

¹⁰⁷ See Court of Justice, cases C-196/04 (Cadbury) and C-425/06 (Part Service).

¹⁰⁸ See for a comparison De Wilde, *supra* note 14, at section 7.

compliance with the freedom of establishment. Moreover, unlimited corporate tax liability for groups in conjunction with a 'credit for domestic tax that is attributable to the foreign income' would have consistently resolved the conceptual challenges that the Court of Justice was faced with in, for example, the Futura and X Holding cases.¹⁰⁹

Second, the legal structuring of the business activities of the group would cease to have any influence on the territorial allocation of the group's business profits. In all circumstances, the profit allocation would take place on the basis of the two-step analysis as developed by the OECD with respect to the allocation of profits realized through permanent establishments. Taking back the recognition of legal reality within the group of affiliated corporate entities would entail that the distortions caused by that assumption would be taken back as well. Hence, treating the group as a taxable unit for corporate tax purposes would render it superfluous to adopt the *ad hoc* measures or 'halfway solutions' mentioned in section 4. Specifically, one may think of measures countering the distortive effects that are caused by the arbitrary:

1. differences in corporate tax treatment between intra-group debt and equity financing arrangements;
2. differences in corporate tax treatment between income realized out of business activities conducted through branches (permanent establishments) and (non-consolidated (foreign)) group companies;
3. jurisdictional mismatches with respect to the territorial allocation of (financing) costs and (business) earnings.

Ad 1. The unlimited tax liability of groups in conjunction with a credit for domestic tax attributable to foreign income would entail that all intra-group financing arrangements would be disregarded for the purpose of levying corporate tax. Accordingly, the current (arbitrary) differences in corporate tax treatment between debt and equity financing transactions within the group would be resolved as the corporate tax treatment of such arrangements would be identical (i.e. non-existent for corporate tax purposes). Traditionally, internal debt financing arrangements within a single corporate entity, i.e. between a permanent establishment and its head office, is not recognized for the purpose of allocating corporate profits to taxing jurisdictions. Notional interest between a permanent establishment and its head office is non-deductible and non-taxable. An impairment of notional debt receivables is impossible. With regards to notional debt financing arrangements, this is for example current international tax law in the Netherlands.¹¹⁰ To my knowledge, the same holds true in many international tax systems with respect to internal equity financing. A notional shareholding between the head office and its permanent establishment is not recognized for corporate tax purposes. In my view, such an approach is conceptually sound. Internal financing arrangements between head office and a permanent establishment do not influence the overall business profit realized by the respective taxpayer.¹¹¹ No value has been added at the level of the taxpayer. Accordingly, there is no economic reality that could support the recognition of notional interest payments or notional dividend distributions (or 'branch remittances') for corporate tax purposes. Cross-border tax consolidation in a manner as advocated in the above would widen the scope of the traditional approach that internal financing arrangements are not recognized for corporate tax purposes to intra-group financing arrangements. In my view, this is the favorable approach. It can be said that intra-group debt and equity financing arrangements, substantially, do not lead to value mutations in the capital of the group, the economic entity.¹¹² From a business economics perspective, intra-group dividend distributions or interest payments do not lead to value mutations for the group as a whole (this only holds true with respect to financing arrangements between third parties). It conflicts with economic reality to recognize intra-group financing arrangements for corporate tax purposes (e.g. allowing a deduction for intra-group interest payments as is the case under virtually all

¹⁰⁹ See Court of Justice, case C-250/95 (Futura) and X Holding, *supra* note 99. See for a comparison Court of Justice, case C-527/06 (Renneberg). For a discussion of this case law, see De Wilde, *supra* note 2, at section 8 and De Wilde, *supra* note 14, at sections 2 to 5.

¹¹⁰ See HR May 7, 1997, BNB 1997/263-264, as well as HR November 25, 2005, BNB 2007/117.

¹¹¹ See for a comparison E.C.C.M. Kemmeren, *Vermogensetikettering bij een vaste inrichting (deel 2)*, WFR 2003/2005, at section 4.2.2.

¹¹² The same is true with respect to other intra-group services rendered and goods supplied. This is left out of consideration.

international tax systems currently in place throughout the world). For the same reason, I do not believe that the trend launched by the OECD to widen the scope of application of the functionally separate entity approach to notional debt financing arrangements between permanent establishments and their head offices is recommendable.¹¹³ Doing so would only lead to the offering of a tool for MNEs to shift their business profits to low-taxing jurisdictions through intra-firm notional debt financing dealings. It would introduce the same problems that international tax systems are currently facing when seeking to tax the proceeds from intra-group financing arrangements. The consequence would be the necessity felt to implement specific measures, such as notional interest deduction limitations, notional thin capitalization rules, or notional earnings and stripping regimes, to counter the subsequent distorting effects caused by extending the functionally separate entity approach to notional debt financing dealings. Just as is the case with respect to intra-group debt financing arrangements in most international tax systems in place today. I would therefore choose another path. Derecognizing intra-group debt and equity financing arrangements for corporate tax purposes in accordance with economic reality is achieved with cross-border tax consolidation (provided that the traditional approach with respect to permanent establishments and their head offices is being maintained). Accordingly, participation exemption or indirect credit mechanisms with respect to (cross-border) intra-group proceeds on equity interests for the purpose of mitigating economic double taxation (paraphrased as “equity interest box regimes”) would become superfluous. There would be no need for such correction mechanisms as there would be no distortions that would need to be countered in the first place.

Notably, from this perspective, the criticized ‘halfway’ solution as proposed by the Dutch State Secretary of Finance on June 14, 2009, to introduce a mandatory group interest box (i.e. an exemption for intra-group interest payments for corporate tax purposes) conceptually is a step in the right direction rather than the adoption of a harmful tax measure as is argued by some tax scholars.¹¹⁴⁻¹¹⁵ There is nothing wrong with derecognizing intra-group debt financing arrangements for corporate tax purposes, simply because no value has been added when one considers things from the perspective of the economic entity, i.e. the group as a whole. Accordingly, the conceptual problem does not lie at the level of the state not taxing the intra-group interest proceed. The conceptual problem lies at the level of the state that allows for the tax deduction of the intra-group interest payments while this is not in accordance with the business economics reality. The jurisdiction from which the intra-group interest has been paid gives rise to problems (disparities) by allowing a tax deduction with respect to economically non-existent debt interests. Consequently, as the non-taxation of intra-group debt proceeds concurs with economic reality (the unitary business approach), regimes exempting such proceeds should not be regarded as illegal state aid or (harmful) tax competition. I nevertheless favor tax consolidation over a group interest exemption regime as tax consolidation would entail the derogation of intra-group debt financing arrangements in jure, rather than on the basis of an ad hoc countermeasure such as a specific exemption regime. Accordingly, in that event, the need to introduce a group interest exemption regime by way of analogy to a group equity interest exemption regime (participation exemption or ‘equity interest box’) would become obsolete.

In addition to this, derecognizing intra-group financing arrangements with a system reform in a manner as described above would also entail that the issues with respect to refinancing arrangements within the group – i.e. the transformation of intra-group debt capital into intra-group equity capital and/or vice versa – for the purpose of benefiting from the differences in the corporate tax treatment of such financing arrangements would become a relic of the past as well. Today, tax systems that provide for a participation exemption or indirect credit mechanism intrinsically allow for the possibility to impair an intra-group debt receivable for corporate tax purposes (and consequently to suffer a tax loss) and subsequently convert the impaired debt

¹¹³ See OECD, *supra* note 66.

¹¹⁴ See for a comparison R. Szudoczky and J.L. van de Streek, *Revisiting the Dutch Interest Box under the EU State Aid Rules and the Code of Conduct: When a ‘Disparity’ Is Selective and Harmful*, 38 Intertax 260 (2010), at p. 260-280.

¹¹⁵ See for a comparison the proposals by Engelen et al, *supra* note 60 and F.A. Engelen, H. Vording en S. van Weeghel, *Eenvoud, evenwicht en een lager tarief vennootschapsbelasting*, WFR 2009/953. See also Consultatiedocument, *supra* note 24. It should be mentioned that the Dutch State Secretary of Finance proposed an 80% exemption, rather than a full exemption as was originally proposed by Engelen et al.

receivable into a corporate shareholding for the purpose of benefiting from a following tax-exempt or creditable increase of the shareholding's worth under the participation exemption or indirect credit mechanisms. In such a case, the deductible tax loss is not compensated with a corresponding taxable profit. Some states, such as the Netherlands, have adopted technically complex measures to counter this undesired effect (no exemption / credit to the extent that the loss has not been recaptured).¹¹⁶ Moreover, various international tax systems which distinguish between intra-group debt and equity financing arrangements intrinsically enable the possibility to finance equity capital payments with debt capital (e.g. a corporate entity lends sums of money from its affiliate to finance a dividend distribution or an equity contribution). By doing this, non-tax-deductible intra-group equity capital payments (dividends, equity contributions) may be arbitrarily converted into tax-deductible intra-group debt capital payments (interest). The Netherlands, again for example, and arguably many other states have adopted specific anti-abuse measures (interest deduction limitations) for the purpose of countering such possibilities.¹¹⁷ Abolishing the recognition of intra-group financing arrangements would deprive the sense of employing such arrangements for the purpose of reducing the corporate tax base. Accordingly, intra-group refinancing arrangements would cease to have any effect with respect to the levying of corporate tax within a given taxing jurisdiction. As a result of this, the various countermeasures as commonly adopted by states to counteract these refinancing arrangements would become obsolete.

Ad 2. With an unlimited tax liability for groups and the tax exemption as a double tax relief method, the sense of specific correction mechanisms aimed at countering the distortive effects that result from the arbitrary differences in corporate tax treatment between income realized out of businesses operated through branches and group companies would disappear. The transparency of group companies that result from applying the tax consolidation would make such countermeasures superfluous as the legal structuring of the business activities of the group would no longer influence the corporate tax liability. The aggregation of current business losses and profits, for example, would apply in jure. Single taxation is achieved in a cross-border context by applying the tax exemption methodology. Consequently, there would be no need for specific profit pooling regimes as currently in place in Germany and Austria ('Organschaft'), the United Kingdom and Ireland ('group relief regime'), Portugal ('Regime Especial de Tributação dos Grupos de Sociedades'), Denmark ('national' and 'international joint taxation regime'), Norway and Finland ('group contribution regime').¹¹⁸ Or, alternatively, the relevance for regimes enabling tax-deductible impairments of equity interests in foreign loss-making group companies (Spain), or liquidation losses set-off regimes (the Netherlands)¹¹⁹ would become obsolete as well. In addition to this, intra-group transactions would be dealt with in a tax efficient manner. In a domestic context, intra-group transactions would not be recognized for corporate tax purposes. In a cross-border context, the application of the separate entity approach would not entail any distortions due to the application of the tax exemption as a double tax relief mechanism.¹²⁰ Accordingly, there would be no need for regimes enabling tax efficient intra-group mergers and acquisitions as intra-group reorganizations would not trigger an immediate corporate tax liability in the first place. Moreover, the same is true for regimes enabling tax-neutral intra-group asset transfers, such as, for example, those currently in place in the United Kingdom and Ireland ('capital gains tax group relief').¹²¹

Ad 3. The recognition of the group as taxable unit would solve the issues which arise from the application of a (gross) participation exemption or indirect credit mechanism to proceeds from foreign (non-consolidated) subsidiaries in combination with the territorial allocation of costs relating to the financing of the shareholdings in these subsidiaries. The application of a participation exemption or indirect credit mechanism in an international tax system has the

¹¹⁶ See Article 13ba Dutch CITA.

¹¹⁷ See Article 10a Dutch CITA.

¹¹⁸ See respectively §§14-19 German Corporate Tax Code, § 9 Austrian Corporate Tax Code, Part 5 UK CTA, Section 420 Irish TCA, Articles 69-71 Portuguese IRC, §§31 and 31A Danish CTA, §§ 10-2 to 10-4 Norwegian TA and Articles 1-8 Finnish KonsAvL.

¹¹⁹ See Article 13d Dutch CITA.

¹²⁰ See De Wilde *supra* note 2, at section 7 and De Wilde *supra* note 14, at section 3.

¹²¹ See Section 171 UK TCGA and Section 617 Irish TCA.

following intrinsic consequence. On the one hand, an exemption or credit is granted at the level of the corporate shareholder with respect to proceeds from foreign subsidiaries. As the subsidiary's business profits are taxed abroad, economic double taxation at the level of the shareholder is mitigated on the basis of an economic double tax relief mechanism (exemption or indirect credit). On the other hand, interest expenses incurred with respect to the financing of the shareholdings in these subsidiaries are nevertheless typically considered to constitute tax deductible items at the level of the corporate shareholder. Consequently, a jurisdictional mismatch occurs between the taxable business profits realized (at the level of the subsidiary in the taxing jurisdiction of source) and the tax deductible costs incurred with respect to the financing of these foreign source business activities (at the level of the corporate shareholder in the taxing jurisdiction of origin). Some states seek to resolve this loophole with deduction limitations for interest payments on intra-group (or sometimes even third party)¹²² debt arrangements. For this purpose, one may think of countermeasures commonly referred to as 'thin capitalization' (e.g. in place in Denmark, France, the Netherlands, Spain, Australia, New Zealand and Japan¹²³) and 'earnings stripping rules' (e.g. in place in Germany, Italy and the United States).¹²⁴⁻¹²⁵

With the unlimited tax liability for groups in conjunction with a credit for domestic tax attributable to foreign income, the financing costs with respect to externally attracted debt capital would be allocated for corporate tax purposes to the geographic location where the group's business activities are actually performed ('debt push down' for corporate tax purposes). The recognition of the group as a taxable unit would involve that interest paid to third parties would be attributed to the geographic location where the group operates its financed business activities on the basis of a functional and factual analysis – as is currently the case with permanent establishments. Consequently, 'branching' the foreign group companies by piercing the corporate veil for tax purposes would lead to a consistent, proportional allocation of external debt interest expenses to the taxing jurisdiction in which the financed business activities are actually performed, irrespective of the legal form chosen by the economic operator in arranging its business affairs.¹²⁶ This approach would in jure resolve the aforementioned jurisdictional mismatch between the taxable business profits realized and the deductible costs incurred with respect to the financing of these respective business activities. Local business activities would be taxed at the net amount. Double tax relief regarding the proceeds from foreign business activities would be granted at the net amount as well. Consequently, there would no longer be any tax incentive for thinly capitalizing group companies through intra-group financing arrangements issued for the purpose of reducing the corporate tax base. Treating the group as one taxable unit for corporate tax purposes would entail that the debt to equity ratio of the group for corporate tax purposes would correspond to the commercial debt to equity ratio of this group. Intra-group financing arrangements would not be recognized. Only third party debt arrangements would. Consequently, an interest deduction limitation (such as a thin capitalization or an earnings stripping rule) would then become redundant.¹²⁷

¹²² The application of interest deduction limitations with respect to third party debt arrangements, in my view, is impossible to justify. I do not see why there would be an objection to grant a tax deduction for interest expenses in that respect. Interest payments to third parties are actual financing costs and should therefore be deductible accordingly.

¹²³ See respectively §11 Danish CTA, Article 212 French CGI, Article 10d Dutch CITA, Article 20 Spanish CITA, Division 820 (Thin capitalisation rules) Australian IITA, subpart FE (Interest apportionment on thin capitalisation) New Zealand ITA and Article 66-5 Japanese SMTL.

¹²⁴ See respectively §4h German Income Tax Code, Article 96 Italian Tax Code and §163(j) (Limitation on deduction for interest on certain indebtedness) US IRC.

¹²⁵ See for a comparison the Consultatiedocument, *supra* note 24 and the Sinterklaasbrief, *supra* note 24 in which the Dutch State Secretary of Finance announced that he was contemplating to propose renewed interest deduction limitations. Under the approach advocated in this article, the contemplated alternative interest deduction limitations would become superfluous.

¹²⁶ See for a comparison Bosal, *supra* note 24. As from the Court of Justice's Bosal ruling, it is possible in the Netherlands to deduct financing costs relating to foreign business activities from the Dutch corporate tax base, yet receiving the proceeds from such foreign operations on a tax-exempt basis under the participation exemption. The unlimited corporate tax liability of groups with a tax exemption for foreign business income would automatically close the loophole in the Dutch international tax system that emerged subsequent to the Bosal ruling (commonly referred to in the Netherlands as the 'Bosalgat', in English: 'Bosal Loophole').

¹²⁷ The problem does not lie with the debtor (i.e., at the expenditure side), but in the fact that most modern corporate tax systems are not adequately equipped to tax the foreign creditor's income (i.e., at the recipient side), see section 6.3.

Moreover, the advocated approach would bring about an equitable and neutral corporate taxation of intermediate shareholders' activities, as well as 'flow-through' and treasury activities. The taxable 'spreads' with respect to the rendering of administrative 'shareholders' services, 'flow-through services' and 'group financing services', that are commonly taken into consideration on the basis of a functional and factual analysis and the at arm's length principle would remain untouched. For example, the economic function of treasury activities performed – i.e. apportioning the group's debt and equity capital attracted from third parties to the various business activities of the group – would be awarded with an at arm's length consideration in accordance with currently applied transfer pricing concepts and taxed accordingly. Notably, 'safe-harbor rules' for the purpose of defining the group's economic substance within a taxing jurisdiction may be of use, yet only to the extent that such rules would not be adopted for the purpose of implicitly providing a tax incentive to attract the aforementioned activities. In my view, this would constitute a harmful tax measure.¹²⁸

6.2 Weighing the pros and cons: the cons

Adopting such an approach would entail various cons – or positively formulated: 'challenges' – as well. As said, the group companies included in the tax consolidation would become transparent for corporate tax purposes within the international tax system of the state applying this approach. The ultimate parent company would become the taxable unit. In cross-border scenarios, the group companies would become branches (permanent establishments) of the ultimate parent company (the 'head office'). The transparency of these group companies for corporate tax purposes would lead to an expansion of hybrid entity issues in the event that other states would keep on taxing affiliated corporate entities on an individual basis. This problem may be solved by having group companies recognized as a permanent establishment of their ultimate parent company. Or even better, as fiscally transparent under the bilateral double tax conventions.¹²⁹

Moreover, where a consolidated foreign group company derives passive income that arises in a third state, which is subject to a source tax in that third state, a triangular case would emerge. This problem may be resolved by requiring the state to which the passive income is attributable on the basis of a functional and factual analysis to grant double tax relief with respect to the foreign source tax levied on the passive income.¹³⁰

Furthermore, as the group would be taxed on its worldwide business income earned, currency issues would occur with respect to the calculation of the double tax relief. Inclusion of the foreign income in the domestic tax base prior to granting double tax relief under the 'credit for domestic tax attributable to the foreign income methodology' would lead to the recognition of as many currency results for corporate tax purposes as the group has business activities in taxing jurisdictions (all employing their own currencies). Save for the exception of scenarios where pragmatic functional currency tax reporting rules have been adopted, this may lead to practical difficulties in determining the amount of double tax relief to be granted. These challenges, however, by no means have to be insurmountable.¹³¹ An alternative to recognize currency

¹²⁸ In my view, the safe-harbor regime as laid down in Article 8c Dutch CITA providing for mild substance criteria may be considered as an example in this respect.

¹²⁹ See for a comparison Brian J. Arnold, *Threshold requirements for Taxing Business Profits under Tax Treaties*, 57 Bulletin for International Taxation 476 (2003), at p. 492. On the basis of Article 5, paragraph 7, OECD Model Convention, subsidiaries are not regarded as permanent establishments of their parent company. It should be noted that e.g. the Dutch Supreme Court nevertheless does not seem to have problems with allowing the cross-border tax consolidation under domestic tax legislation to have effect under the Dutch double tax convention network. See HR March 16, 1994, BNB 1994/191, HR June 29, 1988, BNB 1988/331 and HR November 13, 1996, BNB 1996/47. See for a comparison Lang, *supra* note 104, by way of analogy and Van Raad, *supra* note 104.

¹³⁰ See for example, Court of Justice, case C-307/97 (Saint Gobain) in which the court adopts a similar approach. See also M.F. de Wilde, *Over samenloop van verrekening en vrijstelling onder belastingverdragen*, WFR 2007/855, at section 5.

¹³¹ Theoretically valid solutions have already been developed, for example, by the Dutch Supreme Court in the late 1950s and the early 1960s. See HR May 4, 1960, BNB 1960/163 and HR April 29, 1959, BNB 1960/164 (Rupiah) confirmed by HR March 10, 1993, BNB 1993/209, as well as HR December 5, 2003, BNB 2004/139 (Cruzeiro). Furthermore, see HR March 31, 1954, BNB 1954/180. I will not go into a detailed description of these court decisions at this place. For a discussion of the case law and some numerical examples, reference can be made to C. van Raad, *Cursus Belastingrecht – deel Internationaal Belastingrecht*, at section 2.9.2.C.f.

exchange results for corporate tax purposes would be to exempt them from the taxable corporate base. Although this would be administratively convenient, such an approach would not be conceptually sound.¹³² Currency exchange risks are actual commercial risks. These risks – in the event that they have not been hedged – may lead to actual mutations in the group's equity capital. In my view, this economic reality should be acknowledged for corporate tax purposes, irrespective of the technical difficulties that may emerge from this when calculating the corporate tax liability.¹³³⁻¹³⁴ Market distortions that emerge as a result of mutual fluctuations in exchange rates should be resolved outside the area of corporate taxation. Solutions may, for example, be found in a harmonized monetary policy (such as e.g. the monetary union within the EU).

The allocation of the group's business profits to taxing jurisdictions would take place on the same basis as with respect to the allocation of profits to permanent establishments. The allocation of business income would occur on the basis of the OECD's two-step analysis. The significance of legal transactions between affiliated corporate entities would be strongly reduced. In the event that groups would be treated as a single taxable unit, legal transactions within the group would merely have an indicative value for the purpose of allocating business profits, just as is currently the case with respect to reported internal dealings between a head office and its permanent establishment. This may be regarded as problematical in tax practice. However, it can be considered true that intra-group legal transactions are not necessary means to allocate business income to taxing jurisdictions under the transfer pricing methodology; neither in theory, nor in practice. The possibility to allocate income amongst a permanent establishment and its head office – an environment where legal transactions are absent – on the basis of the two-step analysis proves this thesis. Under the transfer pricing methodology, a factual and functional analysis may suffice to identify the functions performed, the assets used and the risks assumed to which the at arm's length principle is subsequently applied. It has already been applied in international tax practice when business income is allocated to permanent establishments.¹³⁵

Unlimited tax liability for corporate groups in conjunction with a credit for domestic tax attributable to foreign income would lead to considerable changes in the tax auditing and tax return filing practice. The tax returns would be based on the consolidated commercial annual accounts of the entire group rather than the domestic accounts of the part of the group that is being subject to corporate tax within a respective tax system. In addition to this, the (computerized) filing systems employed by the tax authorities would need to be amended. Significant amounts of (possibly to be translated) data should be administered. Taxable amounts would need to be extracted from commercial annual accounts that may be based on various accounting practices (e.g. US GAAP or IFRS). Moreover, with respect to determining taxpayers' corporate tax position, obligations for taxpayers to provide for relevant information, legal remedies, international administrative assistance and cooperation, as well as mutual agreement and arbitration procedures may become even more important than has been the case until today. The need to apply provisions of this nature in the respective states' international tax systems (i.e. administrative provisions in domestic legislation and double tax conventions, as well as the Mutual Assistance Directive and Arbitration Convention in an European Union context) would likely increase. This may lead to administrative difficulties. However, these practical challenges would not necessarily be insurmountable. At the end of the day, it will be the required (political) willingness of states to assist each other administratively that may prove to be the bottleneck for a proper functioning of the approach as advocated in this article. Nevertheless, in the event that the

¹³² See for a comparison, Court of Justice, case C-293/06 (Deutsche Shell).

¹³³ Hedge accounting could be applied for corporate tax purposes in scenarios where the currency exchange risks have been hedged. The aforementioned issues with regard to the corporate tax implications of currency exchange results would then not (at least to some extent) arise as currency risks would not occur.

¹³⁴ In my view, exempting currency exchange results for shareholding interests falling within the scope of application of a participation exemption regime is conceptually unsound for comparable reasons. I believe that such an exemption should only apply for the purpose of securing the single taxation of the underlying (business) profits realized by the company in which the shareholding interest is held. Namely, with respect to currency exchange results realized on the shareholding interest no economic double taxation occurs. Hence, there is no need to apply the exemption for these income items. See for a comparison, Rupiah, *supra* note 131. Contra HR, June 9, 1982, BNB 1982/230.

¹³⁵ Arguments opposing this position can intrinsically be considered as a plea against the conceptual soundness of the transfer pricing methodology (the tool to allocate business income to taxing jurisdictions employed by states today) rather than an argument against the approach advocated in this article.

proposed system would lead to practical problems in assessing corporate tax (e.g. if practice would show that the relevant information for determining the taxpayer's tax position would not be made available), the solution to that problem needs to be sought in improving international administrative proceedings.¹³⁶ The emerging global market just calls for this.

6.3 Remaining challenges to be resolved

The approach advocated in this article would not resolve all theoretical problems. For example, it does not provide for a solution to the remaining market distortions that are caused by disparities (e.g. double (non-)taxation due to differences in income qualification or the interpretation of facts and circumstances for corporate tax purposes). It also does not provide an answer to obstacles imposed by foreign international tax systems.¹³⁷

Moreover, it does not provide an answer to the distortions caused by the inadequacies in the methodology or formula that is generally used by states to divide the 'international tax pie':

First, it would remain troublesome to properly allocate business profits, for instance the MNEs' firm-specific rents, to taxing jurisdictions as the international allocation of income would still take place on the basis of the generally applied but fairly criticized concepts of permanent establishment¹³⁸ and the at arm's length principle¹³⁹. It would remain impossible, for instance, to allocate proceeds from a web store to the origin state under the physically oriented permanent establishment threshold. Moreover, it would remain conceivable, for example, to shift business income to taxing jurisdictions through strategically arranging the transfer prices, for instance with respect to intra-group trading of firm-specific rent-yielding assets, like unique - monopoly rights providing - intellectual property portfolios. As there is no outside market with respect to such unique intangible assets, it is impossible to properly decide on the at arm's length price under a comparability analysis. This provides MNEs with some leeway to reduce their overall tax burden through strategically arranging the intra-firm transfer prices.¹⁴⁰

Second, it would remain troublesome to adequately tax proceeds from inbound investments by *third party* shareholders, creditors, and lessors in the source state.¹⁴¹ Besides the permanent establishment concept, the OECD Model Tax Convention on Income and Capital, the European Union legislation and the international tax systems of various (OECD Member) states typically do not provide suitable instruments in this respect to tax proceeds from (portfolio) shareholders' interests, bonds, leases and license agreements. Despite the fact that these proceeds may very well have been realized within the source state.¹⁴² It is my impression that the reason for this is that the OECD member states are traditionally capital-exporting countries. As a consequence of this, typically, less emphasis has been put on the taxation of proceeds from capital imports in the source country. Consequently, the international tax systems of these states are confronted with difficulties in their attempts to tax the income realized, for example by foreign creditors and licensors in today's globalizing economy. The UN Model Double Taxation Convention provides source states more room to tax proceeds from capital imports (e.g. outbound interest and royalty payments). This may be explained by the fact that the UN Model to a greater extent promotes the interests of the traditionally capital-importing countries (i.e. developing countries and countries with transition economies). It is true that various OECD member states have adopted dividend, interest and royalty withholding tax legislation in their international tax systems. Yet, it should be noted that, in particular within the context of the EU, the levying of withholding taxes in effect is not always possible. The EU Parent-Subsidiary

¹³⁶ See for a comparison De Wilde, *supra* note 2, at sections 4.4 and 7.2.

¹³⁷ See for a comparison De Wilde, *supra* note 2, at sections 2-9.

¹³⁸ See for example Pinto, *supra* note 102, Cockfield, *supra* note 102, at p. 606-619 and Graetz, *supra* note 102, at p. 261-336.

¹³⁹ See for example Kobetsky, *supra* note 106, at p. 201-215, Hellerstein, *supra* note 106, at p. 103-111 and Sadiq, *supra* note 106, at p. 275-286. See also Reuven S. Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, 2 World Tax Journal 3 (2010), at p. 3-17.

¹⁴⁰ See for a comparison Ruud A. de Mooij, *Will Corporate Income Taxation Survive?*, De Economist 153, no. 3, 2005, p. 292 and Avi-Yonah, *ibidem*.

¹⁴¹ See for a comparison Kemmeren, *supra* note 9, at p. 430-452 as well as Kemmeren *supra* note 9, at sections 1 and 6.

¹⁴² See for a comparison Vogel, *supra* note 5, at p. 216-228, 310-320 and 393-402, Kemmeren, *supra* note 9, at p. 430-452 and Kemmeren *supra* note 9, at sections 1 and 6.

Directive, for example, does not consistently allow for the imposition of a dividend withholding tax on outbound dividends to certain foreign minority (third party) shareholding companies. The same is true with respect to withholding taxes on outbound interest and royalty payments to foreign third party creditors and/or licensors under the EU Interest and Royalty Directive. In addition to this, the possibilities for EU Member States to levy source taxes at the gross amount on outbound dividend, interest and royalty payments are also limited in scenarios falling outside the scope of application of these EU Directives. The Court of Justice does not allow EU Member States to levy final source taxes on the gross amount with respect to outbound dividend distributions and interest and royalty payments in the event that economically comparable domestic payments (i.e. payments not crossing the tax border) are exempt from tax or are taxed at the net amount.¹⁴³

Third, the proposal advocated in this article would not provide for a solution to the current (arbitrary) differences in corporate tax treatment between *third party* debt and equity financing arrangements.¹⁴⁴ Proceeds from third party debt financing arrangements would remain to be recognized for corporate tax purposes, while proceeds from third party equity arrangements (at least at the level of the paying agent) would not.

The recognition of these remaining issues however does not make the inferences in this paper invalid. It only proves the invalidity of the assumption, referred to under the third hypothesis, i.e. the origin principle, in section 4, that the methodology generally employed by states to mutually divide the international tax pie operates in accordance with economic reality. It highlights that international taxation requires an adequate tool to identify the income's origin. The solution advocated in this article therefore provides only part of an answer. The place of these remaining pieces in the international tax puzzle remains to be discovered.

7 Concluding remarks

How may states mitigate the distortions they unilaterally impose when taxing MNEs on the corporate business income earned and the capital gains realized within their respective territories? This question has been addressed in this article. An answer lies in tax consolidation: treat the MNE as one taxable unit for corporate tax purposes. For the purpose of defining the group for corporate tax purposes, two criteria should be adopted. Tax consolidation should apply with respect to:

- a) corporate interests that provide the ultimate parent company with a decisive influence over the underlying business affairs of its subsidiaries, provided that;
- b) the parent company holds its corporate interest as a capital asset.

Moreover, tax consolidation should be allowed in both domestic and cross-border scenarios. The group should be subject to an unlimited corporate tax liability in each taxing jurisdiction in which it exceeds a minimum threshold of economic activity. In cross-border scenarios, double tax relief should subsequently be available on the basis of the methodology referred to as the credit for domestic tax attributable to foreign income.

The adoption of such an approach would remove all distortions that are currently caused by the commonly adopted approach to deal with each group company as a single taxable unit (resident or non-resident taxpayer) for corporate tax purposes. The corporate tax treatment of corporate groups and single corporate entities would be brought up to same level in both domestic and cross-border scenarios. It would accordingly cancel out all unilaterally imposed distortions in the corporate taxation of MNEs. Corporate tax burden and revenue levels would not be influenced by the MNEs' legal structuring or the question of whether business is conducted in a domestic or cross-border context. The need for ad hoc correction mechanisms would become superfluous. I favor treating the group as the taxable unit for corporate tax purposes over the separate entity approach basically because such an approach is founded on economic reality. Deal with the group as one entity as it is from a business economics perspective. It simply requires ones acceptance that the problems triggered by taking the separate entity assumption as

¹⁴³ See Court of Justice, cases C-170/05 (Denkavit Internationaal) and C-282/07 (Truck Center), C-379/05 (Amurta) and C-303/07 (Aberdeen). See for a comparison Court of Justice, cases C-234/01 (Arnoud Gerritse), C-345/04 (Centro Equestre), as well as C-265/04 (Margaretha Bouanich).

¹⁴⁴ See De Mooij & Devereux, *supra* note 24.

a starting point in corporate taxation cannot be resolved within the tax framework as is currently built upon it. The bottleneck for a proper functioning of such an approach would lie in the required willingness of states to assist each other administratively.

The approach advocated in this article would not resolve all problems in international taxation. It would not remove market distortions that occur due to remaining disparities or obstacles imposed abroad. Moreover, it would not provide an answer to the distortions caused by the remaining inadequacies in the methodology generally employed by states to mutually divide the international tax pie. The first piece of the international tax puzzle nevertheless seems to have fallen into place. This paves the way for discovering the place of the remaining ones. I hope to address this another day.