

Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy

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1 Introduction

Today we live in a globalizing economy: national open markets are steadily developing towards a global market. Within the European Union (EU), the internal market without internal frontiers has been established. However, the fiscal sovereignty of nation states (hereinafter: 'states') remains limited to economic activities taking place within their territory. Fiscal sovereignty is purely a domestic matter. The combination of a globalizing economy and the geographically restricted fiscal sovereignty of states lead to distortions in the allocation of tax among taxpayers and between states. These distortions are caused by obstacles, disparities and the inadequate 'formula' that is generally used by states to divide the 'international tax pie'.

In this article, I address the question of how these distortions may be dissolved with respect to the taxation of corporate business income in a global market. I will argue that the answer to this question conceptually lies in a worldwide harmonization of tax laws in combination with a transfer of fiscal sovereignty to a supranational body. An unrealistic scenario, as states are unwilling to give up their sovereign powers in the field of direct taxation. The tax sovereignty of states simply needs to be respected as a given. This leaves open the question of how states should dissolve the obstacles they unilaterally impose in their international tax systems. In an attempt to answer that question, I propose a basis for an international tax system without obstacles. Inspired by international tax theory and EU experiences, the proposal is the result of a combination, a *melting pot*, of the – what I believe are – best elements in existing theories, concepts and practices. I combine them into something I refer to as 'internal equity' and 'capital neutrality', which asks for imposition of worldwide taxation on the income of economic operators that meet a minimum threshold of economic activity within a taxing state (such as a business situated in that state). To acknowledge the single tax principle this should be coupled with an equitable and tax neutral form of double tax relief. For that purpose, I refer to the mechanism as currently applied in the Netherlands: the 'credit for domestic tax attributable to foreign income'.

2 Sharing the tax pie

The globalizing economy is dominated by MNEs.² The competence of states to tax the business profits these MNEs realize, however, does not extend beyond national borders. The fiscal sovereignty of a state is limited to economic activities taking place within its geographical territory. With fiscal sovereignty I mean the sovereign right of a state to levy tax for the purpose of financing the public goods provided.³ Fiscal sovereignty is a quintessential feature of a state. It is the instrument with which it expresses its function of redistributing individual well-being in order to optimize the collective well-being of its population.⁴ Without this power of the purse, a state cannot function.

The geographically restricted fiscal sovereignty of states in a globalizing economy entails that tax on corporate income from cross-border business activities should not only be allocated among taxpayers, but also between states: 'sharing the tax pie'.⁵ This requires an allocation methodology, a distributive code, a formula.

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² See Jinyan Li, *Global Profit Split: An Evolutionary Approach to International Income Allocation*, 50 Can. Tax J. 823 (2002), p. 826.

³ See Reuven S. Avi-Yonah, James R. Hines Jr. and Michael Lang, *Comparative Fiscal Federalism – Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence*, EUCOTAX Series on European Taxation, Volume 14, Kluwer Law International, 2007, p. 1.

⁴ See Kevin Holmes, *The Concept of Income - A Multi-Disciplinary Analysis*, IBDT Doctoral Series, Vol. 1, 2001, at chapters 1 and 2 and Victor Thuronyi, *The Concept of Income*, 46 Tax L. Rev. 45 (1990), at pp. 45-105. Income is a surrogate for measuring well-being.

⁵ The term has been derived from Nancy Kaufman, *Fairness and the Taxation of International Income*, 29 Law and Pol'y Intl. Bus. 145 (1998), at p. 153.

The ‘formula’ currently applied in practice for corporate tax purposes seeks to capture the geographic location of a business activity and the business income that is produced (economic presence). It tries to localize geographically the value added in order to place it within the territory of a state that may subsequently tax it.⁶ Key elements in the formula are the taxing principles based on domicile (the residence principle) and situs (the source principle).⁷ Residence and source are determined on the basis of the physical-geographical concepts ‘place of effective management’ and ‘permanent establishment’. These concepts constitute the basis for the tax liability of corporate bodies.⁸ Each (affiliated) corporate body forms a separate taxable unit, and permanent establishments are hypothesized as distinct and separate enterprises (the (functionally) separate entity approach). The application of the residence principle leads to the recognition of resident taxpayers who are taxed on their worldwide income (unlimited tax liability). The application of the source principle leads to the recognition of non-resident taxpayers who are taxed on the income realized within the territory of the taxing state (limited tax liability). The taxable base, the corporate income, is founded on the Schanz-Haig-Simons concept of income (the capital accrual theory).⁹ The residence state ensures that foreign income is not included in the domestic tax base by providing double tax relief (elimination of double taxation). The methods applied in practice are the direct (ordinary) credit for foreign tax and the base exemption for foreign income.¹⁰

Under the formula, the allocation of business income to tax jurisdictions takes place on the basis of legal (recognition of transactions between affiliated entities) and fictitious legal concepts (recognition of internal dealings between a permanent establishment and its head office). The internal transfer price is, again, based on a fiction, the ‘at arm’s length principle’.¹¹ The at arm’s length transfer price is determined on the basis of the physical-geographical concept ‘significant people functions’.¹² The objective of this concept is to allocate business income to the place where the individuals relevant for the business enterprise actually perform the business activities.¹³ In the event that the allocation determined accordingly does not correspond to economic reality, various correction mechanisms - depending on the facts and circumstances - may be applicable (e.g. indirect (imputation) credit or participation exemption regimes with respect to inter-corporate dividend streams, tax consolidation regimes for groups of companies and anti-abuse measures such as intra-group interest deduction limitations seeking to counter

⁶ For a detailed description of these concepts, see Irene J.J. Burgers, *Some Thoughts on Further Refinement of the Concept of Place of Effective Management for Tax Treaty Purposes*, 35 *Intertax* 378 (2007), Brian J. Arnold, *Threshold requirements for Taxing Business Profits under Tax Treaties*, 57 *Bulletin for International Taxation* 476 (2003) and Dale Pinto, *The Need to Reconceptualize the Permanent Establishment Threshold*, 60 *Bulletin for International Taxation* 266 (2006). On profit allocation, see the *OECD Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2008, Danny Oosterhoff, *The True Importance of Significant People Functions*, 15 *International Transfer Pricing Journal* 68 (2008), Burgers, Irene J.J., *Key Entrepreneurial Risk Taking Functions*, NTFR 2005/971 and I.J.J. Burgers, *Subjectiviteit versus objectiviteit bij de toerekening van bedrijfsmiddelen aan vaste inrichtingen*, NTFR 2004/908.

⁷ Supplementary to the source and residence principles is the nationality principle. I leave this out of consideration.

⁸ The income taxation of individuals, as well as the relationship between a corporate income and capital gains tax and an individual income and capital gains tax, is left out of consideration.

⁹ See Holmes, *supra* note 4, at chapter 2. It is noted that States do not implement the theoretical S-H-S concept of income to its full extent in practice. For example, most states do not tax capital gains on an accrual basis, but postpone corporate taxation up until the moment that the capital gain has been realized (the realization principle). However, most states also allow for tax deductible impairments on commercially devalued assets, which have not yet been realized (the principle of due care). The question on whether the S-H-S concept of income is adequately implemented in the international tax systems of states is left out of consideration. See OECD Tax Policy Studies, *Fundamental Reform of Corporate Income Tax*, No. 16, OECD, Paris, 2007.

¹⁰ In the Netherlands, alternatively, the so-called tax exemption method is applied. The tax exemption method basically functions as a credit for the domestic tax that is attributable to foreign income.

¹¹ The at arm’s length principle is a fiction as it assumes that the intra-group transfer price is set as if the affiliates are unrelated (i.e. third parties). However, the economic reality is that the activities take place within the MNE (‘in-house’). The decision to keep the activities in-house is based on economic considerations (the theory of the firm). This reality is ignored under the at arm’s length principle.

¹² See OECD *supra* note 6.

¹³ See OECD *supra* note 6.

profit shifting to low tax jurisdictions through intra group debt financing arrangements).¹⁴ The tax on the so allocated business income is finally determined by applying the tax rate.

The basis of this formula was developed back in the 1920s ('1920s Compromise'). In these early days of international taxation, the League of Nations as the 'predecessor' of the United Nations and the OECD drafted the first Model tax conventions on income and capital. Today's international income and capital gains tax systems (hereinafter: 'international tax systems') of nearly all democratic constitutional states are based on the 1920s Compromise. With the international tax system of a state, I mean the *aggregate* of its national income and capital gains tax system and the network of double tax conventions concluded. With respect to the Member States of the EU, this aggregate of domestic tax laws and double tax convention networks is placed within a framework of supranational EU law.

3 International tax systems distort: obstacles, disparities and inadequacies in the formula

The aggregate of the international tax systems of states distorts the functioning of the globalizing economy. The 1920s Compromise provides for a formula that suits the economic reality in the early days of international taxation. However, globalization, European integration, the rise of MNEs, e-commerce, and intangible assets have changed the world considerably. Today, MNEs show us their ability to affect the jurisdictional allocation of their business income – and with that influence their effective tax rate (ETR) – through (legally) structuring their business activities (tax optimization). This reality exerts great pressure on the international tax systems of states. Many tax scholars conclude from these developments that, today, the formula which resulted from the 1920s Compromise is inadequate to capture the geographic location of a business activity and the business income produced.¹⁵ Somewhere down the road, the formula seems to have become outdated.

The distortions in the international tax systems of states may be categorized in a twofold manner.¹⁶ *First*, distortions occur with respect to the allocation of tax among taxpayers. The tax

¹⁴ Examples of anti-abuse measures are subject to tax clauses, 'switch overs' from exemption to ordinary credit with respect to foreign low taxed passive income, controlled foreign company (CFC-)legislation, and interest deduction limitations. Moreover, one may think of the concepts economic and beneficial ownership.

¹⁵ See Michael Lang (ed), *Source versus Residence, Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives*, EUCOTAX Series on European Taxation, Volume 20, Kluwer Law International, 2008, p. 9-21, Alan J. Auerbach, Michael P. Devereux en Helen Simpson, *Taxing Corporate Income*, Paper Prepared for the Mirrlees Review, "Reforming the Tax System for the 21st Century", 2008, available at http://www.ifs.org.uk/mirrleesreview/press_docs/corporate.pdf, at chapter 4, Michael P. Devereux, *Taxation of outbound direct investment: economic principles and tax policy considerations*, 24 *Oxford Review of Economic Policy* 625 (2008), Michael Kobetsky, *The Case for Unitary Taxation of International Enterprises*, 62 *Bulletin for International Taxation* 201 (2008), p. 201-215, Dale Pinto, *Exclusive Source or Residence-Based Taxation – Is a New and Simpler World Tax Order Possible?*, 61 *Bulletin for International Taxation* 277 (2007), at p. 277-291, Niv Tadmore, *Source Taxation of Cross-Border Intellectual Supplies – Concepts, History and Evolution into the Digital Age*, 61 *Bulletin for International Taxation* 2 (2007), at p. 2-16, 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), p. 430-452, Pinto, *supra* note 6, 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, Walter Hellerstein, *The Case for Formulary Apportionment*, 12 *International Transfer Pricing Journal* 103 (2005), at p. 103-111, Li, *supra* note 2, at 824-844, 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, 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, Kerrie Sadiq, *Unitary Taxation – The Case for Global Formulary Apportionment*, 55 *Bulletin for International Taxation* 275 (2001), at p. 275-286 and Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 *Tex. L. Rev.* 1301 (1996), at chapter 3.

¹⁶ Notably, with the term 'distortion' I mean the influence that the international tax systems of states have on the behaviour of MNEs with respect to the manner in which they, *both actually and legally*, arrange their business affairs. In practice, MNEs, for example, create some modest substance in low tax jurisdictions – e.g. by setting up intermediate holding companies, group financing companies, intellectual property holding companies, or captive insurance companies, which are managed by only a couple of people (who are actually working and present within that jurisdiction) – for the purpose of having the legal allocation of (a substantial part of the MNE's overall) corporate earnings to that tax jurisdiction substantiated for corporate tax purposes in discussions with the tax authorities in high tax jurisdictions (which want their share of the tax pie). Another example recognized in practice is the conversion of 'full fledged distributor and/or manufacturer group companies' established in high tax jurisdictions (high profit level indicators) into low risk distributor

burden on business income differs depending on the question whether or not the respective taxpayer conducts its business activities in a cross-border context. This difference is caused by the fact that fiscal sovereignty lies with the respective sovereign states. Today, there is no supranational body in existence which is competent to levy direct taxes. This category of distortions may be divided into two subcategories: obstacles and disparities.¹⁷

Obstacles occur where the international tax systems of states internally impose a different tax treatment to cross-border business activities in comparison with non-cross-border (i.e. domestic) business activities.¹⁸ The different tax treatment is imposed by a state unilaterally. In practice, obstacles are imposed by states when economic operators enter or exit their domestic markets (restrictions).¹⁹ Moreover, obstacles are imposed by states when states tax economic operators differently depending on their place of residence ((indirect) discrimination). Due to this, internationally active economic operators see themselves hindered when they move between the respective domestic markets. Obstacles imposed where economic operators change tax jurisdiction distort the functioning of the globalizing economy. Within the EU, obstacles distort the functioning of the internal market without internal frontiers.²⁰ MNEs are confronted with obstacles when they are unable to shake them off when arranging their business affairs (legally).

Disparities occur where the international tax systems of states mutually diverge from one another. The differences in the tax treatment of cross-border business activities in comparison with non-cross-border business activities are not caused by states on a unilateral basis (as is the case with obstacles), but find their origin in the parallel exercise of the fiscal sovereignty by the states concerned.²¹ Disparities are the result of mutual divergences in decisions on the respective taxable units, tax bases and tax rates. One can think of differences in (non-)deductible expenses, or depreciation schemes. Other examples of disparities are mutual differences in the qualification and/or interpretation of facts and circumstances for corporate tax purposes: one state considers an income item, for example, as taxable/deductible interest expense, the other state as a non-deductible/exempt dividend distribution. Or the respective states concerned link up with different legal entities as taxable units (hybrid entity issues). Other examples of disparities are (juridical and economic) double or less than single taxation.²² Disparities occurring when economic operators move between tax jurisdictions distort the functioning of the globalizing economy and the internal market. In practice, MNEs employ disparities to influence the ETR on their business income.

Second, distortions occur with respect to the allocation of tax between states. This is caused by the fact that the formula developed in the 1920s Compromise proves to be inadequate in allocating the tax in accordance with economic reality.²³ The formula reveals its flaws in

and/or manufacturer group companies (low profit level indicators) for the purpose of reducing the overall ETR of the respective MNE.

¹⁷ The terminology applied is derived from the case law of the Court of Justice of the European Union (Court of Justice). In my view, distortions resulting from disparities and obstacles also exist outside the context of the European Union (EU). The only difference is that such a situation falls outside the scope of application of the Treaty on the Functioning of the European Union (TFEU). Consequently, there is no supranational judicial body in place which is able to remove these distortions. This does not mean, however, that these distortions do not exist in practice.

¹⁸ Cf. Frans Vanistendael, *In Defence of the European Court of Justice*, 2008 Bulletin for International Taxation 90, p. 96, as well as Frans Vanistendael (ed.), *EU Freedoms and Taxation*, EALTP International Tax Series, Vol. 2, IBFD 2004, Amsterdam, at chapter 1.

¹⁹ With the term domestic markets, I refer to the traditional markets drawn up alongside the domestic borders of states. Notably, in the event that a state unilaterally imposes an obstacle, which, however, in practice is neutralized completely by another state on the basis of the bilateral double tax convention concluded, the obstacle in fact ceases to exist. Cf. Court of Justice, cases C-379/05 (Amurta) and C-43/07 (Arens-Sikken). See Vanistendael, *supra* note 18, at p. 96.

²⁰ Examples of obstacles within the context of the EU can be found in Court of Justice, cases C-319-02 (Manninen), C-446/03 (Marks & Spencer II), C-9/02 (De Lasteyrie du Saillant), C-470/04 (N.), C-307/97 (Saint Gobain) and C-170/05 (Denkavit Internationaal).

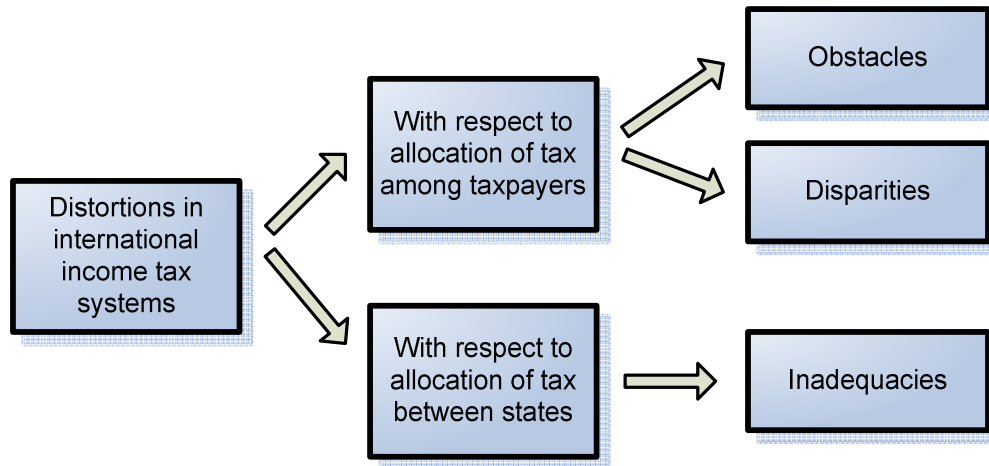
²¹ See Vanistendael, *supra* note 18, at p. 96.

²² A clear-cut example of a disparity (juridical double taxation of cross-border dividends) can be found in Court of Justice, case C-128/08 (Damseaux). See for comparison Article 293 of the former Treaty establishing the European Community (EC Treaty). Under the TFEU, Article 293EC Treaty has been repealed.

²³ See Cockfield, *supra* note 15, at p. 606-619, Pinto, *supra* note 6, at p. 266-279, Pinto, *supra* note 15, at p. 277-291, Hellerstein, *supra* note 15, at p. 103-111, Sadiq, *supra* note 15, at p. 275-286, Kobetsky, *supra* note 15, at p. 201-215 and Graetz, *supra* note 15, at p. 261-336. On transfer pricing, see Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 Va. Tax Rev. 81 (2008), see also Devereux, *supra* note 15, at p. 625-638.

practice. Illustrative are the possibilities for MNEs to shift their corporate costs and benefits respectively to higher and lower tax jurisdictions without materially altering the scope and nature of their business activities. For example, through internal debt financing structures, MNEs employ these possibilities to influence their ETRs. But the formula also proves to be flawed when it comes to the taxation of income from actual business activities. One can think of the difficulties in allocating the income from cross-border e-commerce activities. A web store cannot be captured with the physical-geographical permanent establishment concept. Moreover, it is possible, for example, to shift multinational business income to taxing jurisdictions through strategically arranging the transfer prices 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 these intangible assets, it is impossible to find comparable transactions for the purposes of determining an at arm's length price. This provides MNEs some room to reduce their overall tax burden through strategically arranging their intra-firm transfer prices.²⁴ In addition to this, even the 'significant people functions' concept, as recently developed by the OECD, is under some pressure as a result of the increased mobility of labour. The consequence of these flaws is that the burden of tax on business income differs depending on the fact whether or not the economic operator performs its business activities in a cross-border context. Notably, we are nevertheless dealing with a distortion in the way tax is allocated between states. This may be proven with a thought experiment. Suppose that all the international tax systems would be identical (disparities and obstacles would be gone: the tax burden on cross-border and non-cross-border business activities of economic operators would be exactly the same). In the event that the profit allocation methodology as applied today (separate entity approach, at arm's length principle) would be maintained, the allocation of tax between states would still fail to be in accordance with economic reality. The legal and physical-geographical oriented concepts on which the formula is built, would still prove to be inadequate for the purpose of allocating the tax between states. Just think of the web store and the difficulties in capturing it under the permanent establishment concept (fixed place of business through which the taxpayer's business activities are carried on). Or the impossibility of finding comparable transactions for the purpose of finding an at arm's length transfer price when unique intangibles are transferred within a multinational group of affiliated corporate entities.

Fig. 1. Distortions



4 Conditions for a fair allocation of income tax on business income in a globalizing economy

4.1 Allocation of tax should be equitable and economically efficient

²⁴ See for comparison Ruud A. de Mooij, "Will Corporate Income Taxation Survive?", 153 De Economist 277 (2005), at p. 292.

Is this distortive allocation of tax a problem? I think it is. Inspired by a combination of international tax theory and the objectives underlying the European Union, I will argue that it does not correspond with my view on a fair allocation of tax among taxpayers and between states.

International tax theory requires that the allocation of tax should be *equitable* and *economically efficient*.²⁵ Notions on fairness developed in international tax theory traditionally constitute the underlying normative foundation with respect to the allocation of individual income taxation (IIT).²⁶ In my view, this can also hold true with respect to the allocation of corporate income tax (CIT) as a CIT basically functions as a ‘pre-tax’ preceding an IIT.²⁷

The notions of equity and economic efficiency also lie at the heart of the EU. I believe that the objectives underlying the EU, which align with the common values of the EU Member States, correspond with the notions on which international tax theory has been based. For that reason, *first* a few words on the EU. The objective of the EU is the same as the objective of a developed sovereign state: to promote the well-being of the people living within, in this case, EU territory.²⁸ For that purpose, the EU seeks to establish a common market without internal frontiers on the basis of common social and economic policies ensuring fair (*i.e. equitable*) and free (*i.e. economically efficient*) competition. This entails that all distortions of the common market need to be eliminated.²⁹

The common market requires a harmonization of the tax systems of the EU Member States (‘approximation of laws’).³⁰ Moreover, it requires the abolition of all obstacles to intra-EU movements of goods, services, persons and capital (the ‘free movements’ or ‘fundamental freedoms’). For that purpose, the internal market without internal frontiers has been established. The EU is an autonomous supranational legal order.³¹ EU law has direct effect in the respective domestic legal orders of the EU Member States.

However, the sovereignty of the EU Member States in the field of direct taxation does not substantially differ from the sovereignty of non-EU Member States in this field. With the exception of the prohibition of state aid and a couple of Directives (harmonization), sovereignty in this field currently lies at the level of the EU Member States. A basic principle of EU law in the field of direct taxation is that the founding of the EU did not entail a transfer of competence to levy direct taxes from the EU Member States to the Union. Today, the EU Member States have veto power with respect to any European Commission proposal that involves a transfer of sovereignty in the field of direct taxation to the EU.³² Consequently, within the internal market without internal frontiers, fiscal sovereignty is fragmented into as many autonomous tax jurisdictions as the EU has EU Member States (currently 27). In the field of direct taxation, the internal market without internal frontiers does not (yet) exist. It is ‘work in progress’.

This, nevertheless, does not alter the fact that EU law has a profound influence on the international tax systems of the EU Member States. Established case law of the Court of Justice of the European Union (Court of Justice) reveals that the EU Member States have to *exercise* their competence in direct taxation consistently with the free movements.³³ In cases where the Treaty on the Functioning of the European Union (TFEU) is applicable, obstacles imposed by EU Member States are incompatible with the free movements, unless they are capable of being

²⁵ 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, Kaufman, *supra* note 5, at p. 145-203 and Holmes, *supra* note 4, at chapter 1.

²⁶ See Li, *supra* note 2, at p. 827.

²⁷ See Graetz, *supra* note 15, at p. 301-306.

²⁸ See the preamble to the Treaty on European Union (TEU). Cf. Frans Vanistendael, *No European Taxation Without European Representation*, 9 *EC Tax Review* 142 (2000), at p. 142.

²⁹ Article 2 TEU in conjunction with Articles 26 and 119 TFEU. Cf. Court of Justice, Case 15/81 (Gaston Schul).

³⁰ See Title VII TFEU. See for a comparison Frans Vanistendael, *Memorandum on the taxing powers of the European Union*, 11 *EC Tax Review* 120 (2002). Notably, the free movement of capital also applies outbound investments from EU Member States to third countries.

³¹ See Court of Justice, cases 26/62 (Van Gend & Loos) and 6/64 (Costa/ENEL).

³² Article 115 TFEU.

³³ See Court of Justice, cases C-336/96 (Gilly), Marks & Spencer II, *supra* note 20, C-265/04 (Bouanich), Saint Gobain, *supra* note 20 and Denkavit Internationaal, *supra* note 20. The same applies under the case law of the EFTA Court with respect to the EU Member States of the European Economic Area (Iceland, Liechtenstein and Norway, plus the EU Member States). See EFTA Court, case E-7/07 (Seabrokers).

justified by overriding reasons in the general interest (e.g. on the basis of anti-tax abuse considerations).

Consequently, under the free movements, EU Member States are competent to decide whether or not to tax. Moreover, EU Member States are competent to distribute this competence to tax amongst each other through double tax conventions.³⁴ This means that - just like non-EU Member States - EU Member States are sovereign in their decision on who to tax (taxable unit), what to tax (tax base) and at which rate (tax rate). However, the manner in which this decision is subsequently expressed in that respective EU Member State's international tax system falls within the competence of the EU. This means that the Court of Justice is competent to examine the international tax systems as to their compatibility with the fundamental freedoms.³⁵

The presence of the Court of Justice's case law in direct tax matters reveals a significant *legal* difference between EU Member States and non-EU Member States. EU Member States are subject to a court which is competent to rule that obstacles are incompatible with the fundamental freedoms. In cases where the TFEU is applicable, the Court of Justice can force EU Member States to eliminate the unilaterally imposed obstacles in their international tax systems. Under the fundamental freedoms, the international tax systems of EU Member States may not impose a different income tax treatment on intra-EU business activities in comparison with non-intra-EU (domestic) business activities. Consequently, this supranational legal framework has a profound effect on the EU Member States' tax policy decisions. Non-EU Member States are not subject to such a supranational court. There is no supranational legal framework in place which can force non-EU Member States to eliminate their unilaterally imposed obstacles from their international tax systems. The absence of such a legal framework, however, does not mean that obstacles conceptually do not exist in the international tax systems of non-EU Member States. Absent to a legal authority, there is just no one to tell those states to get rid of the obstacles they unilaterally impose.

Nevertheless, I believe that the EU *notions* on equity and economic efficiency within the internal market may have a general effect in developing ideas on a fair allocation of tax in the global market. It is true that the EU is a supranational legal framework unique in the world. Obviously, EU law has no legal effect outside the scope of application of the TEU. But the EU is not built on unique values. It is built on notions common to 27 developed states in an internal market. And I do not see how this conceptually needs to be different for the developed states outside the EU context and its internal market, but nevertheless within today's globalizing economy. I think that the EU experiences and attempts in dissolving distortions in the field of direct taxation – indeed, together with its perhaps far-reaching consequences in practice – may therefore also have a meaning outside the geographical area within which the supranational EU law applies. Why not?

4.2 Equity

Equity is a moral concept, based on equality.³⁶ Everyone in an economic relationship with a taxing state has the moral obligation to contribute to the financing of public goods from which one benefits ('benefit principle')³⁷ *in accordance* with one's means ('ability to pay principle').

In international tax theory, equity comprises two dimensions: inter-taxpayer equity, on the one hand, and inter-nation equity on the other.³⁸ Inter-taxpayer equity seeks a fair allocation of

³⁴ Cf. Vanistendael, *supra* note 18, at p. 90-98, Vanistendael, *supra* note 30, at section 3 and Frans Vanistendael, *Common (Tax) Law of the Court of Justice*, 16 EC Tax Review 250 (2007), at p. 250-251.

³⁵ In its role as a constitutional court guaranteeing and explaining the fundamental freedoms, the Court of Justice brings the international tax systems of the EU Member States closer to each other (negative integration). 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. 10, and Vanistendael, *supra* note 34, at p. 251.

³⁶ See Vogel, *supra* note 25, at p. 216-228 and p. 393-402. More in detail see Kaufman, *supra* note 5, at p. 145-203 and Holmes, *supra* note 4, at chapter 1.

³⁷ With the benefit principle, I mean the individually immeasurable, but nevertheless present connection (in a broad sense) between the imposition of tax and the public goods provided in return. Note that I do not mean the benefit principle in a strict sense where payments to a governmental body directly result in governmental services being provided (retributions).

³⁸ See further Graetz, *supra* note 15, at p. 297-307, Kaufman, *supra* note 5, at p. 145-203, Vogel, *supra* note 25, at p. 216, Vogel, *supra* note 15, at p. 420-423, Vogel, *supra* note 35, at p. 4-8, Li, *supra* note 2, at p. 824-828, Holmes, *supra* note 4,

tax among taxpayers. This dimension of equity has been developed in a domestic context. The equality principle forms the normative point of departure: equal circumstances should be treated equally and unequal circumstances should be treated unequally to the extent of the circumstances being unequal. As I see it, both the ability to pay principle and the benefit principle result from this notion.³⁹ An example may illustrate things. Corporate taxpayer A operating a shoe selling business enterprise around the corner deserves the exact same corporate tax treatment as corporate taxpayer B operating a taxi service business enterprise across the street. Both equally benefit from public goods provided (public order, infrastructure, legal system, et cetera). Therefore, both should equally contribute their share in financing it. In case they realize a profit, they should be liable to pay corporate tax to a certain amount (as they are able to pay). In the event that they suffer a loss, they should not (as they are not able to pay tax and may even go bankrupt when forced to).

Inter-nation equity seeks a fair allocation of tax between states. This dimension of equity has been developed in a cross-border context in the present system of sovereign nation states. It acknowledges fiscal sovereignty as a given (due to the lack of a supranational body with sovereign taxing powers). More than one taxing state is involved. Say, taxpayer A operating its shoe selling business enterprise resides abroad. And/or taxpayer B operates its taxi service business enterprise across the street, which coincidentally lies across the (tax) border. What difference should such a change in facts make for the question on a fair imposition of corporate tax in a globalizing economy? Conceptually? I would say not much. As I see it, inter-nation equity has its normative foundation in the equality principle as well. It is then referred to as the principle of non-discrimination. But I think that the difference between equality and non-discrimination is merely of a terminological nature. This means that, *again*, both the benefit principle and the ability to pay principle ensue from this.⁴⁰ Let me explain this. Taxpayers A and B benefit from public goods provided. Therefore they should contribute their share in financing it. Both here and abroad. And their contribution in tax should be equal to the contributions of the taxpayers that decided to keep things local and not to cross the border. Otherwise, they would be treated unequally (merely because they decided to cross the tax-border). I do not see how taxpayers operating domestic business activities could find themselves in different circumstances in comparison with taxpayers operating their business activities in a cross-border context. An analysis of a rule or legal construct against the equality principle requires a comparison of the circumstances *in se*: thus without taking into account legal differences as the different legal treatment is *just* the issue under discussion. Otherwise, legal differences would become an argument to plead the inequality of the circumstances. At the end of the day, the sovereignty of states, and with that, the presence of tax-borders is a legal construct. The existence of the EU as a supranational body proves this thesis. Accordingly, domestic and cross-border business activities of taxpayers need to be compared, without taking the presence of the tax-border, a legal construct, into consideration. And when doing that - with a view to a globalizing economy - I fail to recognize how the aforementioned business activities of taxpayers A and B could be considered different.

Moreover, equity requires that business income is taxed only once (the single tax principle).⁴¹ I would say that this holds true in both a domestic and a cross-border context. It

at chapter 1, Tadmore, *supra* note 15, at section 2, Pinto, *supra* note 6, at section 2 and Pinto, *supra* note 15, at section 2. See for a comparison Common Consolidated Corporate Tax Base Working Group (CCCTB WG) 'General Tax Principles, 2004, CCCTB/WP/001Rev1\doc\en, available at:

http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/CCTBWP1FinalRE V1_en.pdf, p. 1-6. Finally, see Robert L. Palmer, *Toward Unilateral Coherence in Determining Jurisdiction to Tax Income*, 30 *Harv Int'l L. J.* 1 (1989), at p. 2-22. Horizontal and vertical equity are left out of consideration.

³⁹ Moreover, the same is true with respect to the legality principle and the principle of legal certainty. See Frans Vanistendael, *Legal Framework for Taxation, Tax Law Design and Drafting*, in: Volume 1, Victor Thuronyi, ed., International Monetary Fund, 1996, at chapter 2.

⁴⁰ I do not see why the benefit principle and the ability to pay principle would not be interrelated - or why these notions would not be taken into account - for the mere reason that it concerns the taxation of corporate income realized in a cross-border context (rather than in a purely domestic context). Notably, this view does *not* correspond with the approach recognized in the OECD and the UN Model Conventions on income and capital (source principle combined with limited tax liability; residence principle combined with with unlimited tax liability).

⁴¹ 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 Vogel, *supra* note 25, at p. 420-423.

would be unfair if taxpayers A and B in aforementioned scenarios would be taxed twice (or less than once) on their income earned. The single tax principle also entails that a group of affiliated corporate entities which jointly operate one integrated business enterprise should be subject to an overall tax burden that corresponds to the tax burden that an independent corporate entity operating a similar business is subject to ('unitary business approach').⁴² The unitary business approach may be recognized in tax consolidation regimes which are often in place in the international tax systems of states. This approach may also be recognized with respect to the Common Consolidated Corporate Tax Base (CCCTB) project with which the European Commission is currently involved. It is impossible to reconcile the unitary business approach with the (functionally) separate entity approach (under which affiliate corporate bodies are taxed as separate taxable units and permanent establishments are hypothesized as distinct and separate enterprises).⁴³ The same is true with respect to the recognition of inter-company transactions and internal dealings for which an at arm's length transfer price should be determined.⁴⁴

4.3 Economic efficiency

Economic efficiency provides an economic foundation for a fair allocation of tax among taxpayers and between states.⁴⁵ Economic efficiency presupposes that the productivity of income is the highest (and with that also the fairest) when the distribution of production factors takes place on the basis of market mechanisms without, or at least as little as possible, public interference. Taxation should merely follow the economic presence of an economic operator and its business income. Taxation should not affect business decisions, neither in a positive nor in a negative manner. An optimal tax, therefore, is one that does not lead to market distortions (tax neutrality).

As with equity, I believe that tax neutrality is founded on equality as well. This means, that, again, the ability to pay principle and the benefit principle result from that. Each business activity should be taxed in the same manner. As I see it, unequal corporate tax treatment in equal circumstances – inequality – distorts business decisions and, with that, the allocation of production factors. Why would an economic operator engage in a certain business activity with respect to which he will be confronted with unequal corporate tax treatment (provided that all other circumstances are the same)? Suppose that our shoe selling taxpayer A would be treated less favourably for corporate tax purposes (A would, for example, be subject to a higher tax burden) in comparison with our taxpayer B operating the taxi service business enterprise. Obviously, A would cease its shoe selling activities and start a taxi service business enterprise like B did (as he would be rewarded with an increase of the after tax profit). Hence, unequal corporate tax treatment influences business decisions. Inequitable corporate tax treatment is economically inefficient (distortive), and vice versa. As I see it, equity and neutrality are interchangeable as they both ensue from the same underlying notion: equality.⁴⁶

Vogel argues that a state should pursue worldwide economic efficiency.⁴⁷ This means that neither the economic operator's place of residence nor the place of his business activities should influence the way he, in effect, is taxed. In a global market national, efficiency and worldwide efficiency necessarily go hand in hand. The (inter)national income tax system of a default state is, or at least should be, founded on ideas on an international tax policy that serves the well-being of that state's people in the broadest sense. As said earlier, the same objective has been pursued by the EU and its Member States. An internationally competitive national open market benefits from an undistorted internationalization of domestic business. I believe that striving for national economic efficiency entails striving for worldwide economic efficiency.

⁴² See Li, *supra* note 2, at p. 828.

⁴³ See Sadiq, *supra* note 15, at p. 276-280 and Kobetsky, *supra* note 15, at p. 202-203.

⁴⁴ See Hellerstein, *supra* note 15, at section 3.

⁴⁵ See Vogel, *supra* note 25, at p. 310-320, Vogel, *supra* note 35, at p. 4-8 and Graetz, *supra* note 15, at p. 269-294. See also Palmer, *supra* note 38, at p. 2-22. I do not question the open market economy in this article. Moreover, I do not go into the question of whether taxation may be used to influence taxpayer behaviour (tax instrumentalism).

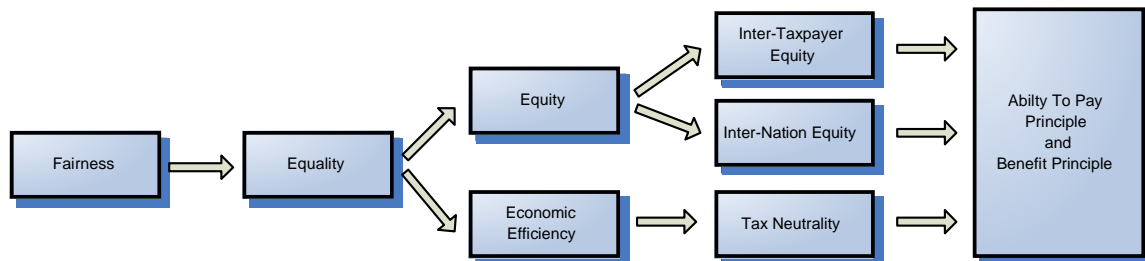
⁴⁶ As unequal tax treatment influences the behaviour of economic operators, I do not recognize – other than is sometimes argued – a trade-off between equity and tax neutrality in this respect.

⁴⁷ See Vogel, *supra* note 25, at p. 310 and Vogel 2002, *supra* note 35, at p. 5.

Consequently, pursuing worldwide efficiency should be a cornerstone of a state's (inter)national tax policy and its (inter)national income tax system.⁴⁸

Economic efficiency also requires neutrality of legal form.⁴⁹ The way business activities are structured legally should be irrelevant for the purpose of levying corporate tax. Legal aspects should not influence the corporate tax base. The reason for this is that legal aspects are of no relevance for answering the question of how much money has been made. At the end of the day, legal aspects are superfluous when it comes to determining the amount of corporate earnings.

Fig. 2. Fairness: eliminating obstacles, disparities and inadequacies



4.4 Administrative convenience

In addition to equity and neutrality, the principle of administrative convenience is generally recognized as well.⁵⁰ The principle of administrative convenience may be viewed from two perspectives, the tax administration's perspective on the one hand and the taxpayer's on the other. The tax administration seeks administrative convenience in the assessment of corporate tax. The taxpayer seeks administrative convenience in complying with the tax laws. In a globalizing economy, obligations for taxpayers to provide information on their international business income, as well as agreements between states on mutual administrative assistance and cooperation, are of great importance. The same is true for offering taxpayers legal remedies, such as mutual agreement and international arbitration procedures. To that end, one can think of the provisions of that nature in the bilateral tax conventions. In an EU context, one can think of the Arbitration Convention in Connection with the Adjustment of Profits of Associated Enterprises (Arbitration Convention) as well as the EU Directive on mutual administrative assistance in tax matters (Mutual Assistance Directive).

In my view, inequality may never be principally refuted on the basis of administrative convenience arguments.⁵¹ This is because the principle of administrative convenience fulfils a different role than equity and neutrality do. It has a practical nature. It deals with the question *whether tax can be assessed* without insurmountable practical difficulties. Other than with equity and neutrality, the principle of administrative convenience does not see to the normative question *how tax should be allocated* among taxpayers and between states. In that respect, the principle of administrative convenience may only impose practical limitations to efforts pursuing equity and neutrality in practice. Hence, a theoretically sound (equitable and economically efficient) allocation of tax cannot be proven false with arguments of an administrative convenience nature. Practical problems ask for practical solutions.

5 Fairness requires international harmonization

⁴⁸ Cf. L.G.M. Stevens, *Fiscale Beleidsnotities 2009*, WFR 2008/1021, at section 4.

⁴⁹ See Vogel, *supra* note 25, at p. 319.

⁵⁰ See Palmer, *supra* note 38, at p. 12 f.f. and Li, *supra* note 2, at p. 829. Cf. Court of Justice, cases C-101/05 (Swedish A) and C-446/04 (FII).

⁵¹ Cf. HR 9 January 2009, V-N 2009/7.5, where the Dutch Supreme Court did not consider administrative difficulties in assessing tax in cross-border scenarios a justification for the unequal tax treatment of resident taxpayers in comparison with non-resident taxpayers in equal circumstances.

At the end of the day, I believe that equity and tax neutrality in the meaning as described in the above conceptually require a worldwide corporation tax system.⁵² Only under that circumstance will it be possible to take away all distortions (obstacles, disparities and inadequacies) in the allocation of corporate tax among taxpayers and between states in a global context.

Prior tax scholarship already produced proposals to come to such a system on the basis of the unitary business approach. An example is a global corporate tax base for business income combined with a tax consolidation regime.⁵³ The so determined global tax base may subsequently be divided between the respective tax jurisdictions on the basis of an allocation key which would reflect the economic presence of the MNE within that tax jurisdiction. It has been proposed to express this key in a metric formula ('global formulary apportionment') or to shape it on the basis of the 'significant people functions' ('global profit split'). In that event, it would become superfluous for corporate income tax purposes where the taxpayer is established. Wherever the business activities are performed, the corporate tax liability - and with that the ETR - would always be the same (provided that the tax rates are harmonized as well). All distortions in the *allocation of tax among taxpayers* would be taken away. As taxation in that event would cease to distort the allocation of production factors, the unitary business approach also finds support in tax neutrality arguments.⁵⁴ On a regional basis, within the context of the EU, the European Commission is actually attempting to have this approach adopted in the EU. In its pursuit of attaining equality in the field of corporate income taxation within the EU, the European Commission is currently working on a proposal for an EU Directive which seeks to adopt a uniform consolidated corporate income tax base for European business enterprises, the so-called Common Consolidated Corporate Tax Base (CCCTB project).⁵⁵

One difficult aspect to be taken into consideration is that the allocation key should be adequate to capture economic reality. And this is exactly what the current 1920s Compromise allocation methodology fails to accomplish. In the event that the new allocation key would be unable to achieve this, it would then be as inadequate as the current one. In that event, the *allocation of tax between states* would still not occur in accordance with economic reality. This looming scenario inspired Auerbach, Devereux and Simpson to propose even more radical changes: a business income tax based on cash flows (destination-based cash flow tax).⁵⁶ Such a tax would link up with goods supplied and services rendered by economic operators. It would basically function as a VAT system (on a cash basis) with a deduction for wages.

Adopting one of the aforementioned approaches necessarily needs to be accompanied with a transfer of tax sovereignty to a supranational body that sets the rules, executes and enforces them, and subsequently settles any disputes that arise. This already proves to be true within the context of the EU. At the end of the day, pursuing the objective of the EU Member States to obtain a common market without internal frontiers requires the transfer of tax sovereignty to the EU.⁵⁷ The harmonization efforts of the European Commission - which are efforts to transfer sovereignty from the EU Member States to the EU at the same time - are illustrative of this. There is no room for tax borders in a European Union without internal frontiers. However, the 1920s Compromise formula, as currently applied by the EU Member States, is based on the current existence of tax borders. Today's reality of 27 different international tax systems of as many EU Member States, all of which are set up alongside tax borders, necessarily cannot coincide with the concept of the common market without internal frontiers. Each difference in the tax burden with respect to intra-EU business activities in comparison with non-intra-EU (or purely domestic) business activities forms a distortion of the internal market which needs to be removed through harmonization.⁵⁸ A common market without internal frontiers can only be

⁵² See Devereux, *supra* note 15, at p. 635.

⁵³ See Li, *supra* note 2, at p. 844 f.f., Sadiq, *supra* note 15, at p. 275-286, Kobetsky, *supra* note 15, at p. 201-215 and Hellerstein, *supra* note 15, at p. 103-111.

⁵⁴ Id. at footnote 52. See also CCCTB WG, *supra* note 38, at p. 1-6 and CPB Document 141, *Will corporate tax consolidation improve efficiency in the EU?*, 2007, available at: <http://www.cpb.nl/nl/pub/cpbreeksen/document/141/doc141.pdf>, at p. 1-87.

⁵⁵ See CCCTB WG, *supra* note 38, at p. 1-6 and CPB, *supra* note 54, at p. 1-87.

⁵⁶ See Auerbach et al, *supra* note 15, at p. 62.

⁵⁷ Cf. Vanistendael, *supra* note 28, at p. 142-143 and Vanistendael, *supra* note 28, at p. 120-129.

⁵⁸ See for a comparison S. Cnossen, *Om de toekomst van de vennootschapsbelasting in de Europese Unie*, WFR 1996/871, at section 4.

realized with a uniform EU corporate tax system. As seen from this perspective, the sovereignty of the EU Member States in direct tax matters today – and with that, an allocation of corporate tax alongside tax borders – is a pragmatic, preliminary, alternative for a genuine common market without internal frontiers.⁵⁹ Hence, EU law in the field of direct taxation as it currently stands finds itself in a transitional period. As I see it, the same may conceptually be held true with respect to the fiscal sovereignty of states in a globalizing economy as, economically, I do not see much difference between an internal market and a global market.

But irrespective of whether the harmonization proposals are appropriate, at this point in time they only exist on the drawing board. And this will remain true for the time being. It is not very realistic that the proposals will be adopted sometime in the near future. The reason for this is that a transfer of tax sovereignty necessarily implies a transfer of sovereignty for international law purposes. After all, the fiscal sovereignty of a state is a quintessential feature of the concept of a state in international law. A state cannot function without the power to tax. And today, states prove to be unwilling to give up their sovereignty in corporate tax matters. This is true, both globally and regionally (e.g. within the EU). It is no coincidence that the harmonization of direct taxation within the EU has been kept limited to a couple of Directives and the Arbitration Convention. Time will tell whether the EU Member States will prove to be willing to adopt the Commission proposals for a CCCTB. Nevertheless, as long as the proposals remain in existence on the drawing board only, there will be no equality in practice. The distortions resulting from the disparities between the international tax systems of states and the inadequacies in the currently applied 'formula' will linger on as long as states fail to harmonize their international tax systems. And as long as states remain unwilling to transfer their fiscal sovereignty, this status quo will not be dissolved. The fundamental freedoms within the EU do not provide a solution for this problem as well.

6 Elimination of obstacles within an international tax system of a state

6.1 What standard has to be fulfilled in order for an international tax system to qualify as 'fair'?

However, this can be seen as *untrue for the obstacles* imposed by states. As already referred to in section 3, obstacles occur where the international tax systems of states internally impose a different tax treatment on cross-border business activities in comparison with non-cross-border (domestic) business activities. The different tax treatment is imposed by states on a unilateral basis. As these obstacles are imposed unilaterally, they can also be taken away unilaterally. This can conceptually be held true for any international tax system, not only that of the EU Member States. The only difference between non-EU and EU Member States in this respect is that in the event that an EU Member State imposes the obstacle, it is the Court of Justice which is legally competent to force that state to eliminate that obstacle from its international tax system (i.e. in cases where the TFEU applies). In the event that a non-EU Member State imposes an obstacle, there is obviously no court in place that may force that state to eliminate the obstacle from its international tax system. This, as said, however, does not mean that obstacles do not exist in the international tax systems of non-EU Member States.

The question how obstacles in the international tax system of a state can be eliminated is preceded by another one: what standard has to be fulfilled in order for an international tax system of a state to qualify as 'fair'? The answer to this question offers the key to a fair (equitable and economically efficient) international tax system: a system without obstacles.

⁵⁹ See for a comparison Frans Vanistendael, *Denkavit Internationaal: The Balance between Fiscal Sovereignty and the Fundamental Freedoms?*, 2007 European Taxation 210. See for a comparison also Manninen, *supra* note 20, Marks & Spencer II, *supra* note 20, Court of Justice, cases C-168/01 (Bosal), C-524/04 (Thin Cap GLO) and C-527/06 (Renneberg). Contra Court of Justice, case C-250/95 (Futura) and D.M. Weber, *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, Kluwer, Deventer, 2006, at p. 11-18. Weber argues by pointing at the Futura case that unilaterally imposed market distortions resulting from EU Member States expressing the territoriality principle in their international tax systems are disparities.

Inspiration for an answer to this question can be found in international tax theory.⁶⁰ In addition to this, leads can also be found in the case law of the Court of Justice on the fundamental freedoms with respect to direct taxation. With every preliminary question on the fundamental freedoms in the field of direct taxation, the Court of Justice sees itself confronted with one question: does EU Member State X impose an obstacle when applying tax measure Y?⁶¹ Yes or no? All things being right, one would expect that the Court of Justice, when answering this question, would adopt the same approach each and every time. Consequently, this should enable one to derive the underlying standards that the Court of Justice adopts from its case law. And these standards may provide the key to an international tax system without obstacles.

6.2 Equity within the international tax system of a state

In section 4.2, I note that equity is a moral concept, founded on the principle of equality. As said, everyone in an economic relationship with a taxing state has the moral obligation to contribute to the financing of public goods from which one benefits (benefit principle) in accordance with one's means (ability to pay principle).

A founding feature of the international tax system of a state is the single tax principle: a corporate taxpayer's business profits should be taxed once by one state.⁶² As I see it, equity *within* a tax system requires that the level of tax should be determined by making (a rough) reference to the public goods provided by the taxing state (benefit principle).⁶³ Corporate taxpayers should contribute to the financing of public goods provided by a state irrespective of their place of residence, as soon as their economic presence within that state exceeds a certain minimum threshold.⁶⁴ Examples of thresholds applied by states in practice are the concepts of permanent establishment and the place of effective management. With respect to the determination of the corporate tax burden in that state, it should be immaterial where the corporate taxpayer is resident (equality principle). The income that, for example, our taxpayer A realizes out of its shoe selling business enterprise should be taxed equally irrespective of whether taxpayer A resides here or abroad. As argued in section 4.2, the ability to pay principle should be respected as well. For the purpose of determining a taxpayer's corporate tax burden in that state, I think that it should *also* be immaterial whether the business profits are realized solely within that state or spread out across various other states (equality principle). Suppose that our taxpayer A now conducts its shoe selling business enterprise in a cross-border context: A operates one shoe selling business around the corner and one abroad. Should that make a difference in determining A's local corporate tax liability? Is it equitable when A's local tax burden alters due to the mere decision of opening a shoe store abroad? I would say no, as I do not recognize a change in circumstances in these altered facts. Both the overtaxation as well as the undertaxation of cross-border business activities in comparison with non-cross-border (domestic) business activities should be considered unfair.⁶⁵

Within the context of the EU, the Court of Justice recognizes the equality principle as explained in the above paragraph under the fundamental freedoms in cases where the TFEU applies. In general, the Court of Justice's approach is fairly distinct. Provided that the TFEU applies, all economic operators, which employ one of the free movements, may rely on being subject to the same national tax rules for market participation in the domestic markets of the respective EU Member States, irrespective of their place of residence (the market equality

⁶⁰ See for a comparison Vogel, *supra* note 25, at p. 216-228, p. 310-320 and p. 393-402, Kaufman, *supra* note 5, at p. 145-203, Holmes, *supra* note 4, at chapter 1 and Kemmeren, *supra* note 15, at p. 430-452.

⁶¹ See for a comparison Vanistendael, *supra* note 59, at p. 210-213.

⁶² See Avi-Yonah, *supra* note 38, at p. 131.

⁶³ Even though the relationship between taxes paid and public goods received cannot be measured, this does not mean that such a relationship is therefore not present.

⁶⁴ See Avi-Yonah, *supra* note 41, at p. 131. See also Vogel, *supra* note 15, at p. 420-423.

⁶⁵ See Li, *supra* note 2, at 827. This, in itself obvious consideration, is not followed in international taxation. Illustrative is the substantial flow of Court of Justice case law on the fundamental freedoms in the field of direct taxation.

principle).⁶⁶ In the event that a Member State disregards the principle of market equality by taxing economic operators differently, depending on their place of residence, this Member State imposes an *obstacle* (discrimination). As a result of this, economic operators see themselves hindered when moving between the domestic markets of the respective EU Member States. Obstacles imposed by EU Member States when they see economic operators cross their tax borders (changing tax jurisdictions) distort the functioning of the internal market. Consequently, obstacles are incompatible with the fundamental freedoms. Moreover, they do not only distort the functioning of the internal market; in my view, obstacles also distort the functioning of the globalizing market (as said, I see no conceptual difference between the internal market and the global market).

According to the Court of Justice, residents and non-residents are in a comparable position as soon as a Member State exercises its fiscal sovereignty over them.⁶⁷ Resident and non-resident taxpayers find themselves in equal circumstances, since the taxing state exercises its taxing powers on both of them. For tax purposes, this means that a non-resident deserves to be treated equally to a resident by an EU Member State as soon as this EU Member State decides to tax this non-resident. For example, due to the fact that this non-resident operates through a branch (a permanent establishment) situated in that EU Member State, or is subject to a source tax (e.g. on a dividend, interest or royalty payment). This entails that the economic operator's place of residence should be of no relevance whatsoever when it comes to determining its tax burden in an EU Member State. Notably, this does not correspond with the residence principle as employed in the OECD and the UN Model Conventions on income and capital (limited tax liability for non-resident taxpayers versus unlimited tax liability for resident taxpayers in combination with double tax relief).⁶⁸

However, under EU law in the field of direct taxation as it currently stands, the principle of equality does not imply unimpaired. For example, the concept of 'most favoured nation treatment' as an expression of the equality principle is not acknowledged by the Court of Justice. EU law as it currently stands seems to allow EU Member States, in my view for indistinct reasons, to treat residents of other EU Member States differently in comparison to residents of third EU Member States. For example, in the *D.* case, the Court of Justice allowed the Netherlands to treat non-resident taxpayers residing in Germany differently (allowance for wealth tax was refused) in comparison with non-resident taxpayers residing in Belgium and Dutch resident taxpayers (allowance for wealth tax was granted).⁶⁹ In addition to that, non-intra-EU (or purely domestic) business activities fall outside the scope of the TFEU. With respect to such purely domestic activities, economic operators have to resort to the equality principle as applied in the domestic legal order of the respective Member State. An example of this is found in the Flemish social security insurance case.⁷⁰ Under the Flemish social security insurance under scrutiny in this Belgian case, the Walloons were treated differently from Flemish and other EU citizens, despite the fact that they found themselves in equal circumstances. The Court of Justice allowed Belgium to maintain this different treatment as it considered the unfavourable treatment of the Walloons a purely domestic situation. The Walloons had to resort to the equality principle as laid down in the Belgian Constitution.

Nevertheless, the Court of Justice has recently taken a big leap forward towards the recognition of the 'EU resident' for tax purposes. In the *Renneberg* case, the Court of Justice

⁶⁶ Cf. Vanistendael, *supra* note 18, at p. 90-98. See also Vanistendael (ed.), *supra* note 18, at p. 106. The same may be true for residents of non-EU Member States in the event that the EU has concluded an association agreement with that state containing provisions (with direct effect) dealing with free movements of goods, services, persons and capital.

⁶⁷ Cf. *Renneberg*, *supra* note 59, *Denkavit Internationaal*, *supra* note 20, *Amurta*, *supra* note 19, as well as Court of Justice, case C-303/07 (*Aberdeen*). Cf. B.J.M Terra and P.J. Wattel, *European Tax Law*, Fifth Edition, *Fiscale Studierieserie* nr. 29, Kluwer Deventer, 2008, at p. 393. Contra Court of Justice, cases C-279/93 (*Schumacker*) and C-385/00 (*De Groot*).

⁶⁸ See for a comparison E.C.C.M. Kemmeren, *Renneberg Endangers the Double Tax Convention System or Can a Second Round Bring Recovery?*, 18 *EC Tax Review* 4 (2009) at p. 4-15.

⁶⁹ See Court of Justice, cases C-376/03 (*D.*) and C-298/05 (*Columbus*). But Cf. Court of Justice, case C-196/04 (*Cadbury*). Cf. H.J. Noordenbos, *Unilaterale begunstiging strijdig met het EG-Verdrag*, WFR 2009/79.

⁷⁰ See Court of Justice, case C-212/06 (*Flemish social security insurance*). Notably, Advocate-General Sharpston (without success) made a plea for extending the scope of the TFEU to purely domestic scenarios by pointing at the concept of the common market without internal frontiers.

sees an obstacle in the tax treatment of foreign source income items of non-resident taxpayers in comparison with the tax treatment of foreign source income items of resident taxpayers in the Netherlands.⁷¹ The Netherlands allows its resident taxpayers to include negative income items from foreign sources in the domestic (i.e. Dutch) tax base (*worldwide taxation*). With respect to the foreign income of resident taxpayers, the Netherlands provides double tax relief on the basis of the so-called ‘tax exemption’ method. This method basically functions as a credit for the Dutch income tax that is attributable to the foreign source income items. I explain this method in some detail in section 7.1. On the contrary, the Netherlands does not allow non-resident taxpayers to include negative income items from foreign sources in the Dutch tax base. The foreign income of non-resident taxpayers is exempt from Dutch tax (*territorial taxation*). By doing this, in effect, the Netherlands provides ‘double tax relief’ to non-resident taxpayers through a ‘base exemption’. Consequently, resident taxpayers (worldwide taxation & double tax relief through tax exemption) are treated differently (in this case less favourably) in comparison with non-resident taxpayers (source taxation & ‘double tax relief’ through ‘base exemption’). The difference in tax treatment is based solely on the taxpayer’s place of residence for tax purposes. In the Renneberg case, the Court of Justice observed that the Netherlands, by doing this, imposes an obstacle (discrimination) that cannot be justified by overriding reasons in the general interest.⁷²⁻⁷³ Consequently, this obstacle has to be eliminated from the Dutch international tax system.

The Renneberg case has far-reaching consequences. In this respect, it should be noted that equality in a manner which the Court of Justice requires can only be achieved by *removing* the current distinctive tax treatment based on the taxpayer’s residence. The taxpayer’s residence has to be removed as a relevant factor in determining the tax burden in the Netherlands. This can only be achieved by adopting worldwide taxation for both residents and non-resident taxpayers once the Netherlands exercises its sovereign taxing powers. With respect to the foreign sourced income items, double tax relief will have to be provided by applying the tax exemption mechanism.⁷⁴ Notably, this approach does not correspond with the distinctive tax treatment of resident (worldwide taxation in combination with double tax relief for foreign income) and non-resident taxpayers (territorial taxation) as currently applied by most states in practice.⁷⁵

6.3 Tax neutrality within an international tax system

As mentioned in section 4.3, economic efficiency is based on the presumption that the productivity of income is the highest (and with that also the fairest) when the distribution of production factors takes place on the basis of market mechanisms without, or at least with as little as possible, public interference. Taxation should not affect business decisions, neither in a positive nor in a negative manner (tax neutrality).⁷⁶

As I see it, tax neutrality *within* an international tax system requires that, in the event that a state exercises its sovereign taxing powers, the tax burden in that state on business income earned is always the same. This should be irrespective of whether the business activities are performed solely in that state or spread out across various states. In addition to this, it should be irrespective of where the economic operator has its place of residence.

Suppose that the tax burden in a state differs depending on the economic operator’s place of residence or whether or not the business activities are performed in a cross-border context. For example, our taxpayer B - the one that operates its taxi service business enterprise across the street - resides abroad. Or suppose that our taxpayer B conducts two taxi service

⁷¹ See Renneberg, *supra* note 59. Contra Futura, *supra* note 59.

⁷² Unfortunately, the Court of Justice took the ‘Schumacker route’ (personal allowances) rather than a Marks & Spencer II approach (territoriality and anti-abuse). Cf. Terra et al, *supra* note 67, at p. 51.

⁷³ But see D.M. Weber, annotation Vakstudie Highlights & Insights 2008/2.4. Weber recognizes a disparity in Renneberg, *supra* note 59, and bases this on Futura, *supra* note 59.

⁷⁴ Application of a territorial system to resident taxpayers (base exemption for foreign income) leads to inequality. See section 6.3.1.

⁷⁵ See for a comparison Kemmeren, *supra* note 68.

⁷⁶ As I believe that taxation should not influence business decisions, I do not see how tax competition between states in order to attract foreign investment could function as an efficiency-enhancing element of international taxation. I only see room for competition between states in attracting foreign investment through optimizing their administrative net output. Contra, Schön, 1 World Tax Journal 67 (2009), at p. 78-79.

businesses: one across the street and one across the border. In the event that taxpayer B's local corporate tax burden would differ depending on the place of his residence, or the question of whether or not B operates its taxi business enterprise both across the street and abroad (the taxing state, for example, levies a corporate tax on hidden reserves that becomes due upon corporate emigrations or cross-border intra-firm asset transfers (exit tax), or the taxing state disallows cross-border aggregation of business profits and losses realized), this would influence B's decision on keeping things local or crossing the tax border. Such an inconsistency (i.e. different tax treatment triggered by aforementioned movements) within the international tax system of this taxing state would influence business decisions. Taxpayer B would think twice before crossing the tax border of this state. After all, as soon as he crosses it, he will be subject to a different tax burden in that state. As the international tax system of this state unilaterally influences business decisions, it unilaterally distorts the functioning of the globalizing economy. In my view, this is undesirable.

The same holds true within the context of the EU. From the Court of Justice's case law it can be derived that tax neutrality constitutes a cornerstone principle of EU law. Provided that the TFEU applies, the fundamental freedoms guarantee that economic operators, who employ one of the free movements, can move their business activities freely between the respective domestic markets of the EU Member States ('market access' or 'market neutrality principle').⁷⁷ In the event that EU Member States infringe the market neutrality principle by taxing economic operators differently as soon as they move their businesses between the respective domestic markets of the EU Member States, these EU Member States unilaterally impose an obstacle (restriction). The tax treatment differs depending on whether the respective economic operator performs its business activities in an intra-EU or in a domestic context. Obstacles imposed by EU Member States when they see the economic operators' business activities cross their tax borders (changing tax jurisdictions) distort the functioning of the internal market. This is incompatible with the fundamental freedoms.

Intra-EU business activities and non-intra-EU (or purely domestic) business activities are comparable, as soon as an EU Member State exercises its sovereign taxing power on these activities,⁷⁸ for example, due to the presence of a permanent establishment within the territory of that EU Member State, or through levying a source tax. Every business activity performed within the territory of a Member State that is taxed by that state is comparable and, hence, deserves the same tax treatment. Consequently, the tax burden imposed by that state should be indifferent to whether the business activities are performed solely in that EU Member State or spread across various EU Member States. This does not correspond with the source principle (territorial taxation) as employed in the OECD and the UN Model Conventions on income and capital.⁷⁹

EU law as it currently stands also acknowledges the neutrality of legal form. The legal structuring of a business activity seems irrelevant under the freedom of establishment. Established case law of the Court of Justice reveals that EU Member States prove to be sovereign in their decisions on the taxable unit and the level where they attribute the tax liability. EU Member States are, for example, free to decide on the transparency of a legal entity for tax purposes (e.g. a partnership) and to tax the persons behind it (e.g. underlying partners or shareholders).⁸⁰ However, in order to guarantee tax neutrality, EU Member States may not unilaterally distort the economic operator's choice of the legal form when structuring its intra-EU business activities. Consequently, indicative in identifying an obstacle is the plain comparison between the intra-EU and the non-intra-EU business activity, irrespective of the manner in which

⁷⁷ See Vanistendael, *supra* note 18, as well as Vanistendael (ed.), *supra* note 18, at p. 107. The same may be true for residents of non-EU Member States in the event that the EU has concluded an association agreement with that state containing provisions (with direct effect) dealing with free movements of goods, services, persons and capital.

⁷⁸ Cf. Court of Justice, cases C-397/98, C-410/98 (*Metallgesellschaft / Hoechst*), *FI*, *supra* note 50, *Marks & Spencer II*, *supra* note 20, C-293/06 (*Deutsche Shell*), C-231/05 (*Oy AA*) and C-414/06 (*Lidl*).

⁷⁹ See for comparison *Kemmeren*, *supra* note 68 at p. 4-15

⁸⁰ See *Columbus*, *supra* note 69 and the Opinion of A-G Maduro on *Marks & Spencer II*, *supra* note 20. *Saint Gobain*, *supra* note 20, as well as Court of Justice, cases C-311/97 (*RBS*) and 270/83 (*Commission/France*). Cf. HR 8 February 2008, BNB 2008/135, where the Dutch Supreme Court applied a 'see-through' approach with respect to the subsidiaries of a Dutch resident corporate taxpayer outside EU territory that were indirectly held through an intermediate holding company which was established within EU territory.

this business activity is structured legally.⁸¹ In an internal market without internal frontiers, I think that this may be true irrespective of the direction of the investment, thus with respect to both origin (outbound investments) as well as host state (inbound investments) cases.

6.3.1 CEN and CIN both distort unilaterally

With these remarks on tax neutrality, clarity in this matter ends. In my view, neither EU law as it currently stands nor international tax theory currently hands over a theoretically sound tax neutrality concept. Today's tax neutrality concepts do not hold water.

The traditional and generally accepted neutrality concepts are capital export neutrality (CEN) and capital import neutrality (CIN).⁸² CEN addresses the residence or origin state with respect to outbound capital movements. *Taxation under CEN links up with the place of residence (or the place of effective management) of the recipient of the (business) income* (subject approach). Under CEN, the basic assumption is that the tax burden on the taxpayer's income in the state of its residence should be the same irrespective of the geographical location (locally or abroad) where the income has been produced. The tax burden should be the same irrespective of where the income has been earned. The *ability to pay principle* as an expression of the equality principle can be recognized in this approach. CEN is generally associated with worldwide taxation in the residence state in combination with an (ordinary) credit (or imputation credit) for the (underlying) tax levied in the source state.

CIN addresses the source or host state with respect to inbound capital movements. *Taxation under CIN links up with the place where the taxpayer's income has been produced* (object approach). Under CIN, the basic assumption is that the tax burden on the income produced within the source state's territory should be the same irrespective of the place of residence (or the place of effective management) of the recipient of the income (taxpayer). The place of the taxpayer's residence is irrelevant. The *benefit principle* as an expression of the equality principle can be recognized in this approach. CIN is usually associated with a territorial, source-based, system (or with a system of worldwide taxation in the residence state combined with a base exemption with respect to income realized in the source state).

Vogel argues that the opposite CEN and CIN neutrality concepts cannot exist simultaneously, when achieving worldwide economic efficiency constitutes the common underlying objective.⁸³ CEN and CIN merely address one-sided (respectively outbound / inbound) capital movements, rather than the aggregate of cross-border inbound *and* outbound capital movements. CEN disregards (and therefore distorts) inbound capital movements. CIN disregards (and therefore distorts) outbound capital movements. This is caused by the fact that CEN and CIN only address one dimension of equality, i.e. respectively the ability to pay principle and the benefit principle.

Vogel demonstrates that CEN treats economic operators who perform their economic activities in both the residence state and abroad differently (unequal and therefore non-tax neutral) in comparison with economic operators who perform their economic activities solely in their residence state.⁸⁴ In the event that the residence state subjects both to the same domestic tax burden, the residence state imposes an obstacle to the economic operator investing abroad. Abroad, i.e. in the source state, the tax burden and the public goods granted in return lie on another level than in the residence state. Consequently, under CEN, economic operators going abroad pay tax on their foreign source income at the residence state level, but in return receive the benefits from public goods provided at the (different) source state level. This is in accordance with the ability to pay principle, but *not* in accordance with the benefit principle. By applying a CEN policy to resident economic operators going abroad, the residence state ignores the connection between the level of taxation and the public goods provided in return. On the contrary,

⁸¹ Cf. Opinion Advocate-General Wattel, 11 September 2008, V-N 2008/47.14.

⁸² See Vogel, *supra* note 25, at p. 310-320 and Vogel, *supra* note 35, at p. 4-8. See also Graetz, *supra* note 15, at p. 269-294 and Kemmeren, *supra* note 15, at section 3. Notably, Kemmeren refers to Capital and Labour Import Neutrality (CLIN) and Capital and Labour Export Neutrality (CLEN). Moreover, Schön, *supra* note 76, at p. 71 and 81-82, recognizes the concept of 'capital ownership neutrality' (CON). I will leave this out of consideration.

⁸³ See Vogel, *supra* note 25, at p. 313 and Vogel, *supra* note 35, at p. 5.

⁸⁴ See, Vogel, *supra* note 25, at p. 310-320. See also Kemmeren *supra* note 15, at section 3.

this is not the case with the economic operator who performs its activities solely in the residence state. This leads to inequality in the source state caused by the residence state. The economic operator going abroad suffers a competitive disadvantage in the source state in comparison with locally active economic operators, in the event that the level of taxation in the residence state exceeds the level of taxation in the source state and the residence state taxes the excess (ordinary (imputation) credit). In that case, the economic operator going abroad pays tax at a higher level than its local competitors, but, nevertheless, benefits from the same (lower level) public goods. The economic operator going abroad benefits from a competitive advantage in the source state in comparison with locally active economic operators when the level of taxation in the source state exceeds the level of taxation in the residence state and the residence state would pay out the difference (full credit). In that case, the economic operator going abroad pays tax at a lower level than its local competitors, but, nevertheless, benefits from the same (higher level) public goods. Both outcomes distort inbound capital movements in the source state. These distortions are unilaterally imposed by the residence state. Consequently, CEN leads to obstacles.

The application of the ordinary credit method in practice requires a specific justification. In my view, a justification for the (ordinary) credit method may lie in applying it as a correction mechanism for the inadequacies in the 'formula' that resulted from the 1920s Compromise. Since the formula as applied today is inadequate in capturing economic reality, the credit method may be deployed as an anti-tax abuse tool to counteract the sheltering of volatile production factors (such as liquid assets and intangibles) in low taxing jurisdictions.⁸⁵ Presented like this, the credit method functions as an anti-tax abuse measure in the fight against harmful tax competition.

CIN also has certain shortcomings attached to it. CIN treats economic operators who perform their economic activities both within the source state as well as abroad differently (unequal and therefore non-tax neutral) in comparison with economic operators who perform their economic activities solely within the source state. If the source state subjects both to the same domestic tax burden, the source state imposes an obstacle on the economic operator investing abroad. Income that is not attributable to the source state (foreign income) is left out of consideration when determining the tax burden in the source state. This is in accordance with the benefit principle, but *not* with the ability to pay principle. When determining the domestic tax burden, the source state ignores the ability of the economic operator investing abroad to pay tax. On the contrary, this is not the case with economic operators solely investing in the source state. Their ability to pay is taken into consideration. This leads to inequality caused by the source state. Outbound capital movements are distorted unilaterally by the taxing source state. CIN, hence, leads to obstacles.

In international tax literature, the obstacles imposed under CIN are sometimes referred to, or labeled, as "dislocations" and are subsequently considered as an inherent (and therefore justified) consequence of applying a territorial tax system.⁸⁶ In my opinion, dislocations are merely another designation for unequal treatment in equal circumstances: the term dislocation then becomes just another (and therefore basically superfluous) word for discrimination. A numerical example may illustrate the obstacles imposed in a territorial system. Suppose, in situation 1, taxpayer Q realizes income from sources (e.g. branches a) and b) situated in State X. State X applies a territorial tax system. The operations in branch a) yield a positive return (profit) of 100. The operations in branch b) yield a negative return (loss) of 40. State X takes taxpayer Q's ability to pay into account, permits horizontal loss compensation (compensation of losses realized within the tax year) and taxes Q for the on balance business income amounting to 60. Suppose, in scenario 2, the same taxpayer Q realizes the loss of 40 from the operations in branch b), now situated in State Y. All of a sudden, in situation 2, State X does not take the taxpayer's ability to pay into consideration, does not permit horizontal loss compensation, and taxes Q for the income of 100. State X solely takes into account the profit realized out of the operations in branch a) situated in State X and disregards the loss suffered in branch b) situated in State Y. By assessing

⁸⁵ See for a comparison the remarks by the Dutch Ministry of Finance in 1998 on the Dutch international tax policy, the 'Notities inzake het Nederlands fiscaal verdragsbeleid', V-N 1998 No. 22, at section 1.3.2 en 4.3.1.3, which refers to adopting CEN from anti-tax abuse considerations.

⁸⁶ See Terra et al, *supra* note 67, at p. 48. See also D.M. Weber, *Vpb 2007. Een stelsel gebaseerd op het territorialiteitsbeginsel: EG aspecten en contouren*, WFR 2004/1297, at section 3.2.2.

the taxable income of taxpayer Q in situation 2 at 100 instead of 60, State X does not take taxpayer Q's ability to pay into consideration, where it does in the comparable situation 1. In the event State X applies a proportional tax rate, Q's tax burden in State X increases with a factor of 1.667. Only because taxpayer Q crossed State X's tax border by *repositioning* branch b) to State Y, State X unilaterally imposes an obstacle. Even in the event that State Y acknowledges the loss of 40, allows vertical loss compensation (compensation of losses realized in another tax year) by carrying the loss forward to the next tax year, the obstacle imposed by State X remains in place. Because even under the presupposition that taxpayer Q will be able to realize a profit from the operations in branch b) situated in State Y in the next year, taxpayer Q still suffers a liquidity disadvantage in situation 2 in comparison with situation 1 due to the unfavourable tax treatment of taxpayer Q in State X. After all, taxpayer Q is deprived of the tax paid on the difference between 100 and 60 for a period of one year. All territorial, CIN-based, tax systems do not take the economic operator's ability to pay into account and, consequently, impose an obstacle. The Netherlands, for example, imposes such an obstacle on its non-resident taxpayers. One only has to read 'the Netherlands' in 'State X' and 'non-resident taxpayer' in 'taxpayer Q' to reach this conclusion. And it was exactly this disadvantage that triggered the Court of Justice in the Renneberg case to consider the difference in tax treatment between non-resident taxpayers in comparison with resident taxpayers in the Dutch international income tax system to be discriminatory.⁸⁷

Dislocations can lead to both competitive advantages (e.g. income splits at progressive rate structures) and competitive disadvantages (e.g. negative income items realized out of cross-border business activities) for economic operators going abroad in comparison with economic operators staying at home. In the aforementioned numerical example of our taxpayer Q who went abroad, the dislocation (foreign income items are kept outside the domestic tax base in the source state) ends in an unfavourable fashion.

Within the context of the EU, unfortunately EU law as it currently stands does not provide a consistent tax neutrality concept as well. Both primary and secondary EU law do not give preference to CIN or CEN or the corresponding double tax relief methods (i.e. respectively exemption and credit).⁸⁸ In fact, in its case law, the Court of Justice considered the application of both CIN and CEN by EU Member States both compatible and incompatible with the fundamental freedoms.⁸⁹ The absence of an EU tax neutrality concept leads to complications. For example, where EU Member States – such as the Netherlands⁹⁰ and Germany⁹¹ – apply anti-tax abuse provisions switching over from exemption (CIN) to (in)direct credit (CEN) in cases where corporate taxpayers shelter liquid assets in low tax jurisdictions. Primary EU law as it currently stands does not provide an answer to the question whether one is here dealing with an acceptable double tax relief method⁹², or an anti-tax abuse measure that needs to be justified by

⁸⁷ Cf. Renneberg, *supra* note 59. But see Weber, *supra* note 86, at section 3.2.2.

⁸⁸ See Vogel, *supra* note 35, at section 3 and Kemmeren, *supra* note 14, at section 4. Cf. Gilly, *supra* note 33, FII, *supra* note 50 and Columbus, *supra* note 69, as well as the EU Interest & Royalty (CEN) and Parent-Subsidiary (CEN and CIN) Directives.

⁸⁹ With respect to the Court of Justice's approach towards CIN, see Futura, *supra* note 59 (Court of Justice: "distortion due to application of CIN is disparity"). Divergent approaches can be found in Renneberg, *supra* note 59 (Court of Justice: "distortion due to application of CIN is unjustified discrimination"), Bosal, *supra* note 59 (Court of Justice: "distortion due to application of CIN is unjustified restriction"), Marks & Spencer II, *supra* note 20 (Court of Justice: "distortion due to application of CIN is restriction that may be justified"), and Lidl, *supra* note 78 (Court of Justice: "distortion due to application of CIN is restriction that may be justified"). With respect to CEN, see Columbus, *supra* note 69 (Court of Justice: "distortion due to application of CEN is not an obstacle"). Divergent approaches can be found in Court of Justice, case C-336/96 (Gilly), *supra* note 33 (Court of Justice: "distortion due to application of CEN (second limitation in ordinary credit method) is a disparity"), FII, *supra* note 50 (Court of Justice: "distortion due to application of CEN is a disparity"), and Cadbury, *supra* note 69 (Court of Justice: "distortion due to application of CEN (application CFC-legislation) is restriction that may be justified on the basis of anti-tax abuse considerations").

⁹⁰ As of January 1, 2007, the Dutch international tax system introduced a fixed indirect credit mechanism for so-called 'passive low taxed participations'. In the event that a Dutch corporate taxpayer disposes of such a participation, the Dutch Corporate Income Tax Act (CITA) switches over from the application of the participation exemption to the application of the credit mechanism. The regime is currently laid down in Article 13 io. Article 23c of the Dutch CITA.

⁹¹ I.e. the 'switch-over' which was at stake in Columbus, *supra* note 69.

⁹² See Columbus, *supra* note 69.

overriding reasons in the general interest⁹³.⁹⁴ Taking the aforementioned shortcomings with the CEN concept into account, I think it should be the latter.⁹⁵

As an alternative to CIN and CEN, Vogel introduces the concept of ‘inter-nations neutrality’.⁹⁶ Vogel argues that worldwide economic efficiency is best promoted when states do not employ their sovereign taxing powers to influence the relative prices in other states. Pointing at the *benefit principle*, Vogel concludes that worldwide economic efficiency requires that an economic operator that performs economic activities within a state or a domestic market, and with that utilizes the public goods provided by that state, should be ensured that its tax burden is the same as any other who, in similar circumstances and to the same extent, utilizes the public goods provided by that state (inter-nations neutrality).⁹⁷ Vogel argues that inter-nations neutrality can only be achieved by allocating the profits from cross-border business activities to the geographic location where the economic activities actually take place and where the business income is produced (economic presence).⁹⁸ I have the impression that Vogel’s neutrality concept basically functions in a manner similar to CIN. By only taking the benefit principle into account and, hence, *without considering the ability to pay principle*, the application of the inter-nations neutrality concept as proposed by Vogel leads to the dislocations that I consider to be discriminatory obstacles in the above.

In sum, both CEN and CIN (or internations neutrality) result in unequal tax treatment in equal circumstances. Hence, adopting one of these neutrality concepts in an international tax system inevitably leads to unilaterally imposed obstacles. As a result of this, in my view these concepts are insufficient as an overall tax neutrality concept.

7 Fairness within an international tax system

7.1 Internal equity and capital neutrality

As CEN and CIN lead to inequality and, with that, to obstacles, it is necessary to develop an alternative. Something else is needed. The alternative neutrality concept has to meet the following preconditions. The fiscal sovereignty of states needs to be respected as invariable (notably, as in this part of the article, I am searching for a solution to unilaterally imposed *obstacles*, rather than a solution to the *disparities* and *inadequacies* as mentioned in section 5). The neutrality concept needs to offer equality between cross-border and non-cross-border business activities, irrespective of the manner in which the capital movement is directed (i.e. inbound/outbound). Both the benefit principle and the ability to pay principle need to be acknowledged. This means that whenever a state exercises its sovereign taxing powers and subjects an economic operator (taxpayer) to tax, the tax burden in that state should be equal, irrespective of the taxpayer’s place of residence or effective management (the benefit principle). In addition to this, the burden of tax should be equal irrespective of whether this taxpayer realizes its business income solely in that state or across various states (the ability to pay principle).

These presuppositions boil down to the following norm: *the domestic tax burden on the income realized out of the cross-border business activities of taxpayers should be equal to the domestic tax burden on the income realized out of the non-cross-border (i.e. purely domestic) business activities of taxpayers*. In the event that the tax burden differs, an obstacle has been imposed by that taxing state. Namely, in that case, the difference in the tax burden can necessarily only be caused by the taxpayer’s place of residence or the fact that the taxpayer operates its business activities across various states.

⁹³ Cf. Cadbury, *supra* note 69 and Opinion Advocate-General Mengozzi in Columbus, *supra* note 69.

⁹⁴ The decision of the Court of Justice in Columbus, *supra* note 69, for a ‘double tax relief approach’ instead of an ‘anti-tax abuse approach’ as it did in Cadbury, *supra* note 69 and Court of Justice, case C-425/06 (Part Service) consequently seems to be based on arbitrary grounds.

⁹⁵ See for a comparison Vogel, *supra* note 35, at section 3.

⁹⁶ See Vogel, *supra* note 25, at p. 313-315 and Vogel, *supra* note 35, at p. 4-8. See also Kemmeren, *supra* note 15, at p. 438-441 and Pinto, *supra* note 6, at p. 266-269.

⁹⁷ See Vogel, *supra* note 25, at p. 314. Vogel refers to the connection between the benefit principle and the efficiency of the administrative machinery of government (‘administrative net output’).

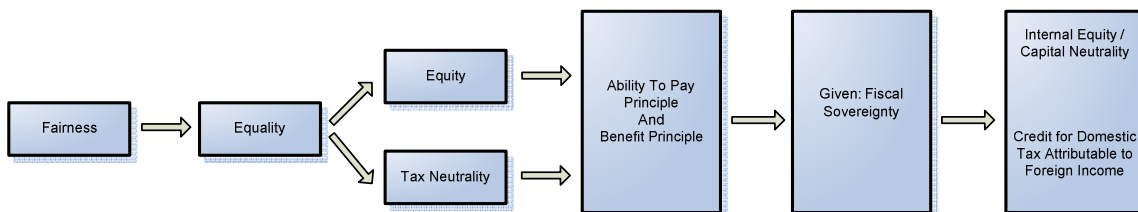
⁹⁸ See Vogel, *supra* note 15, at p. 420-422.

This norm can be achieved by combining the – what I believe are – best elements in existing theories, concepts and practices. CIN and CEN are telescoped into one another. From the CEN concept, I extract the element ‘worldwide taxation’. By doing this, the ability to pay principle is acknowledged. From the CIN concept, I extract the element ‘economic presence’. Through this, the benefit principle is acknowledged.

This exercise results into *unlimited tax liability* for the worldwide business income of the respective economic operator, irrespective of its place of residence (or effective management). The taxpayer’s unlimited tax liability within a tax jurisdiction arises when the taxpayer conducts a business that is situated within the territory of that respective tax jurisdiction. The threshold of a minimum economic presence has then been met. Due to the current lack of adequate alternatives to grasp the geographic ‘source’ of business income in practice (see section 3), one may link up with the currently generally applied source concepts, such as the concept of permanent establishment. The place of effective management may qualify as a permanent establishment.⁹⁹ In this way, a concept has been modeled that results into equality (equity and neutrality) within an international tax system for taxpayers changing tax jurisdictions. I plainly refer to it as internal equity and capital neutrality.

At the same time, the fiscal sovereignty of states needs to be respected as a given. Single taxation of the taxpayer’s business income realized should be ensured as well. In order to respect the fiscal sovereignty of states and to achieve single taxation of the taxpayer’s business income, the adoption of an internally equitable and capital neutral double tax relief method is required. As the common (ordinary) credit for foreign tax (CEN) and the (base) exemption for foreign income (CIN) methods prove to be flawed, an alternative is necessary. The required double tax relief method may be achieved by (again) telescoping the credit (CEN) and exemption (CIN) methods into one another. The result of this exercise is the ‘*credit for the domestic tax that is attributable to the foreign income items*’, a double tax relief methodology I extract from Dutch tax law (by analogy). This double tax relief mechanism has been applied in the Netherlands with respect to the foreign income items of Dutch resident (corporate) taxpayers since 1914.¹⁰⁰ The mechanism is commonly referred to as the ‘tax exemption with progression method’. It however functions as a credit for the Dutch (corporate) income tax that is attributable to the foreign source income items. Notably, due to the current lack of adequate alternatives for the geographic allocation of business profits in practice (i.e. the inadequacies, see section 3), one may link up with the currently generally applied (functionally) separate entity approach and the at arm’s length principles (transfer pricing methodology).

Fig. 3. Fairness within an international tax system of a state: elimination of obstacles



Before leaping to an exploration of the meaning, implications and consequences of this approach in a numerical example in section 7.2, I would first like to devote some words to the

⁹⁹ In this respect, one may also consider the other source concepts currently in place, such as the place where the immovable property is situated, the place where the company paying the dividends has its effective place of management, or the place where the interest and royalties arise. With respect to source taxes levied on portfolio dividend, interest and royalty payments one may think of crediting them against corporate tax levied. With respect to transactions within a group of affiliated companies (inter-corporate dividends and inter-company transactions), one may think of adopting (mandatory) cross-border tax consolidation arrangements or arrangements dealing with the (mandatory) transparency for corporate tax purposes of group companies. These issues, however, exceed the scope of this article and will, therefore, not be discussed in detail.

¹⁰⁰ This double tax relief methodology is laid down in the Dutch Unilateral Double Tax Relief Decree of 2001 (Besluit voorkoming van dubbele belasting 2001).

mechanics of this double tax relief methodology as it is currently applied in the Netherlands. The Netherlands allows its resident taxpayers to include negative income items from foreign sources in the domestic tax base. It reserves the right to include foreign source income items (both positive and negative) in the domestic tax base in the bilateral double tax conventions that it has concluded ('tax base reservation' or in Dutch: 'grondslagvoorbehoud'). Subsequently, the Netherlands provides for double tax relief with respect to the foreign income items that are included in the Dutch worldwide tax base ('tax base requirement', in Dutch: 'grondslageis').

The double tax relief methodology is best explained by way of an example. Year 1. 'Default scenario'. The business income of a Dutch resident corporate taxpayer Z from its Dutch source a) adds up to € 140,000.00. Z's business income from foreign source b) in State X adds up to € 60,000.00. Z's worldwide income is consequently € 200,000.00. Suppose that the corporate tax rate in State X is a linear 18%. Suppose that the Netherlands applies a progressive tax rate in the Dutch Corporate Income Tax Act (CITA). And suppose that the tax brackets are arranged as follows:

Fig. 4. Tax Brackets

Rate (%)	Tax base	Aggregate Tax
10%	0 – 50,000	-
20%	50,000 – 100,000	5,000.00
25%	100,000 – excess	15,000.00

A's corporate tax liability is determined in two steps. First, the Dutch tax on Z's worldwide income is calculated. The Dutch tax on Z's worldwide income amounts to € 5,000.00¹⁰¹ + € 10,000.00¹⁰² + € 25,000.00¹⁰³ = € 40,000.00. Second, the double tax relief is calculated by making reference to the Dutch tax that is attributable to the foreign income. The methodology works in the same way as the second limitation commonly applied with respect to the ordinary credit method. For the purpose of calculating the double tax relief, the following fraction is applied: (foreign income / worldwide income) * Dutch tax on worldwide income. In the example, the application of the fraction leads to double tax relief amounting to € 12,000.00.¹⁰⁴ The Dutch tax payable is accordingly set at € 40,000.00 - € 12,000.00 = € 28,000.00, an effective tax rate in the Netherlands of 20% on the Dutch share of the tax pie (€ 140,000.00). In this way, the progressivity in the Dutch tax rate is respected.¹⁰⁵ Please note that the amount of foreign corporate tax payable (€ 10,800.00¹⁰⁶) with respect to the foreign income of € 60,000.00 is completely ignored for the purpose of calculating the double tax relief in the Netherlands.¹⁰⁷

In the case of resident taxpayers suffering foreign and/or domestic source losses, single taxation on cross-border business income is realized respectively through the application of the so-called 'recapture of foreign losses method' ('inhaalregeling') and the 'carry forward of foreign profits method' ('doorschuifregeling'). Again, these methods are best explained by way of an example.

The recapture of foreign losses method. Suppose that, all other things being equal to the default scenario, the Dutch resident corporate taxpayer Z suffers a loss from its source b) in State X adding up to € 60,000.00 in year 1. As the foreign loss is taken into account for the purpose of calculating the domestic tax base (horizontal loss compensation), Z's taxable base amounts to €

¹⁰¹ 10% * 50,000.00.

¹⁰² 20% * 50,000.00.

¹⁰³ 25% * 100,000.00.

¹⁰⁴ 60,000.00 / 200,000.00 * 40,000.00

¹⁰⁵ Application of a (distorting) base exemption for foreign income (CIN) would lead to a payable Dutch tax of € 25,000.00 (10% * 50,000.00 + 20% * 50,000.00 + 25% 40,000.00). This would lead to a 'dislocation' favouring taxpayer A in comparison with its competitors staying at home (due to the income split) amounting to € 3,000.00 (28,000.00 – 25,000.00).

¹⁰⁶ 18% * 60,000.00.

¹⁰⁷ The application of a (distorting) ordinary credit for foreign tax (CEN) would lead to a payable tax of € 29,200.00 (€ 40,000.00 – 10,800.00). This would lead to a competitive disadvantage for taxpayer A in State X (discrimination) amounting to € 1,200.00 (€ 29,200.00 - € 28,000.00)

80,000.00.¹⁰⁸ As a result of this, the Dutch tax payable amounts to € 11,000.00 (i.e. 5,000.00 + 6,000.00).¹⁰⁹ There will be no double tax relief provided as Z suffered a loss abroad. In addition to this, Z receives an administrative notice from the tax inspectorate that the loss of € 60,000.00 will be recaptured as soon as Z manages to realize positive income from its foreign source b) in a following year. Suppose that, in year 2, taxpayer Z realizes a profit from of its source b) in State X of € 80,000.00, all other things being equal to the default scenario. In year 2, Z's worldwide income is consequently € 220,000.00.¹¹⁰ As said, the double tax relief is determined in two steps. First, the Dutch tax on Z's worldwide income is calculated at € 5,000.00 + € 10,000.00 + € 30,000.00¹¹¹ = € 45,000.00. Second, the double tax relief is determined. The year 1 loss of € 60,000.00 is recaptured in year 2 (recapture of foreign loss). Technically, this entails that the numerator in the fraction decreases by 60,000.00 to 20,000.00 (i.e. 80,000.00 – 60,000.00). The reduction of the numerator in the fraction leads to a reduction of the double tax relief provided. This ensures that the year 1 loss suffered is taken into account only once (instead of twice). The double tax relief provided for in year 2 amounts to € 4,090.00.¹¹² The Dutch tax payable in year 2 is accordingly set at € 40,910.00.¹¹³ As a result of this mechanism, the loss is taken into account when suffered and single taxation has been guaranteed as well. Please note that, again, the foreign corporate tax consequences (e.g. local loss set-off possibilities) are ignored.

The carry forward of foreign profits method. Suppose that, all other things being equal to the default scenario, the Dutch resident corporate taxpayer Z suffers a loss from its source a) in the Netherlands adding up to € 140,000.00 in year 1. As this domestic loss is taken into account for the purpose of calculating the domestic tax base (horizontal loss compensation), Z's taxable base consequently amounts to € 80,000.00 negative.¹¹⁴ As a result of this, the Dutch tax payable amounts to nil. There will be no double tax relief provided as the tax payable in the Netherlands is already nil. Alternatively, Z receives an administrative notice from the tax inspectorate that the foreign profit of € 60,000.00 will be carried forward to a following year in which Z manages to realize positive income from its domestic source a). Suppose that, in year 2, taxpayer Z realizes a profit out of its domestic source a) of € 200,000.00, all other things being equal to the default scenario. In year 2, Z's worldwide income is consequently € 260,000.00.¹¹⁵ The double tax relief is determined in two steps. First, the Dutch tax on Z's worldwide income is calculated at € 5,000.00 + € 10,000.00 + € 40,000.00¹¹⁶ = € 55,000.00. Second, the double tax relief is determined. The year 1 profit of € 60,000.00 from source b) in State X is carried forward to year 2 (carry forward of foreign profits). Technically, this entails that the numerator in the fraction increases by 60,000 to 120,000.00 (i.e. 60,000.00 + 60,000.00). The increase in the numerator in the fraction leads to an increase of double tax relief provided. The double tax relief provided for in year 2 amounts to € 25,385.00.¹¹⁷ The Dutch tax payable in year 2 is accordingly set at € 29,615.00.¹¹⁸ This mechanism ensures that the year 1 profit realized abroad is taken into account once (rather than not at all). Single taxation is guaranteed as well. Again, the foreign corporate tax consequences are ignored.

The 'credit for domestic tax attributable to foreign income' *methodology* entails that the tax burden in the Netherlands remains the same, irrespective of whether resident taxpayer Z carries out its business activities in a cross-border context or not. There is neither an incentive nor a disincentive imposed by the Netherlands for taxpayer Z crossing the tax border. Both the

¹⁰⁸ 140,000.00 – 60,000.00.

¹⁰⁹ 5,000.00 + 20% * 30,000.00. The application of a (distorting) base exemption for foreign income (CIN) would lead to a payable Dutch tax of € 25,000.00 (10% * 50,000.00 + 20% * 50,000.00 + 25%. 40,000.00) on an income of € 140,000.00. This would lead to a 'dislocation' disfavoring taxpayer A in comparison with its competitors staying at home (due to the negative income items realized abroad) at the amount of € 14,000.00 (25,000.00 – 11,000.00), an increase of the tax burden at a factor of roughly 2,28 (2,28 * 11,000 ≈ 25,000.00).

¹¹⁰ 140,000.00 + 80,000.00

¹¹¹ 25% * 120,000.00.

¹¹² (80,000.00 - 60,000.00) / 220,000.00 * 45,000.00.

¹¹³ 45,000.00 - 4,090.00.

¹¹⁴ 60,000.00 - 140,000.00.

¹¹⁵ 200,000.00 + 60,000.00

¹¹⁶ 25% * 160,000.00.

¹¹⁷ (60,000.00 + 60,000.00) / 260,000.00 * 55,000.00.

¹¹⁸ 55,000.00 - 25,385.00.

ability to pay principle and the benefit principle are respected. From a unilateral perspective, changing tax jurisdictions consequently takes place in a tax neutral and equitable manner.¹¹⁹

Unfortunately, the Netherlands applies this double tax relief method only to its resident taxpayers. With respect to the foreign income items of its non-resident taxpayers, the Netherlands applies a territorial system. As a result of that, the Netherlands, materially, provides for 'double tax relief' by way of a 'base exemption' for the foreign income of non-resident taxpayers. In the Renneberg case the Court of Justice has determined that this distinctive tax treatment is incompatible with the fundamental freedoms. Consequently, the Netherlands seems to be in need of another double tax relief methodology with respect to its non-resident taxpayers (e.g. through extending the application of the tax exemption methodology to them).

7.2 The route to Rome: unlimited tax liability in a tax jurisdiction when economically present there; credit for the domestic tax that is attributable to the foreign income items

In my view, the double tax methodology as explained in the above provides fairness within the context of my internal equity / capital neutrality concept. Under my approach, *unlimited tax liability* within a taxing jurisdiction arises as soon as the economic operator is economically present within that taxing jurisdiction. The taxpayer's place of residence is irrelevant. The taxpayer is taxed for the worldwide business income realized. This would cancel out all (discriminatory) differences in tax treatment between resident and non-resident taxpayers currently in place in the international corporate tax systems of states. The fiscal sovereignty of states and the principle of single taxation are respected by applying double tax relief with respect to the foreign income. The methodology applied is the *credit for domestic tax attributable to foreign income*. Application of this methodology would cancel out all (restrictive) differences in tax treatment between taxpayers moving their business activities between the respective domestic markets of states and taxpayers maintaining their business activities within the domestic market of a single state. Tax abuse may be tackled with a subject to tax clause,¹²⁰ i.e. the application of the double tax relief mechanism may be subject to the prior requirement that the foreign income is subject to a corporate tax. In this way, the foreign source income of taxpayers is kept outside the domestic tax base in an equitable and economically efficient manner. Obstacles are gone. It is noted that taking these steps requires a fundamental change in the way tax of thinking on the concepts of source combined with territorial taxation (limited tax liability) and residence combined with worldwide taxation (unlimited tax liability) in the field of international taxation today.

Suppose that disparities are absent (i.e. all international tax systems would follow the proposed approach). Suppose that the 'formula' that resulted from the 1920s Compromise would be adequate to capture the geographic location of the income produced. The corporate tax treatment of a cross-border business activity would be exactly the same as the tax treatment of a non-cross-border activity. With respect to corporate taxation, it would be immaterial whether the taxpayer has its place of residence in Amsterdam, Paris, Tokyo or New York. It would also be immaterial where the business activities are performed. The tax liability - and with that the effective tax rate - would always be the same. The tax pie would be shared in accordance with economic reality. Fairness in the allocation of corporate tax among taxpayers and between states would be achieved.

The way my proposed system would work under these circumstances may be illustrated by the following numerical example.¹²¹ In year 1, taxpayer A (his place of residence is irrelevant) realizes business profits from sources (branches) 1 and 2 in State X. The profits realized from source 1 are 200 positive. The profits realized from source 2 are 50 negative. In year 2, the profits which A realizes from source 1 are 200 positive. The profits realized from source 2 are 100 positive. Figure 5 deals with the scenario where both sources are situated in State X. Figure 6 deals with the scenario where source 1 is situated in State X and source 2 in State Y.

¹¹⁹ Contra De Groot and Schumacker, *supra* note 67. Cf. Terra et al, *supra* note 67, at p. 393.

¹²⁰ Cf. Vogel's remarks, *supra* note 35, at p. 6.

¹²¹ The double tax relief methodology also functions in an equitable and economically efficient manner with respect to internal dealings (e.g. internal supplies of goods and internal services provided). Numerical examples (by way of analogy) can be found in C. Van Raad, *Cursus Belastingrecht (Internationaal Belastingrecht)*, at section 2.9.2.

Fig. 5. Domestic scenario

Taxpayer A	Income in Year 1
Source 1 (branch in State X)	200
Source 2 (branch in State X)	<50>
On balance	150
Corporate tax (say 25%)	37,5

Taxpayer A	Year 2
Source 1 (branch in State X)	200
Source 2 (branch in State X)	100
On balance	300
Corporate tax (say 25%)	75

Fig. 6. Cross-border scenario

Taxpayer A	Year 1	Worldwide income	Corporate tax (25%) before double tax relief	Credit for domestic tax attributable to foreign income	Recapture foreign losses (administrative notice)	Carry forward foreign profits (administrative notice)	Corporate tax (25%) after double tax relief
Source 1 (branch in X)	200	150	37.5	0	50	0	37.5 (in X)
Source 2 (branch in Y)	<50>	150	37.5	37.5 ¹²²	0	50	0 (in Y)
On balance	150	150	37.5	n/a	n/a	n/a	37.5

Taxpayer A	Year 2	Worldwide income	Corporate tax (25%) before double tax relief	credit for domestic tax attributable to foreign income	Recapture foreign losses	Carry forward foreign profits	Corporate tax (25%) after double tax relief
Source 1 (branch in X)	200	300	75	12.5 ¹²³	0	0	62.5 (in X)
Source 2 (branch in Y)	100	300	75	62.5 ¹²⁴	0	0	12.5 (in Y)
On balance	300	300	75	n/a	n/a	n/a	75

The tax burden of taxpayer A is the same in both scenarios. It is irrelevant where A has its place of residence for tax purposes. It is irrelevant whether taxpayer A performs its business activities solely in State X or spread across States X and Y. The corporate tax would be allocated in accordance with economic reality. A and its business activities can move unhindered within the global market. States X and Y receive their share of the tax pie. Fairness in the allocation of tax among taxpayers and between states has been achieved.

However, disparities do exist. And the formula that resulted from the 1920s Compromise is inadequate (due e.g. to the flawed source concepts and transfer pricing methodology). Consequently, market distortions caused by disparities and inadequacies remain in place when this mechanism, as proposed, would be adopted. However, these distortions will no longer be the result of an obstacle. This issue has been resolved. The resulting market distortions would then only be caused by disparities and inadequacies in the formula as defined in section 3. These distortions may only be removed through harmonization (see section 5).

A similar system as described in the above has been proposed by Van Raad in the late 1990s with respect to the taxation of individuals who have their place of residence within the territory of the EU (“fractional taxation”).¹²⁵ Conceptually, I do not see any reason why such an

¹²² 150/150 * (25% * 150)). The fraction is maximized at 1 (150/150 instead of 200/150) as State Y would otherwise pay out tax to taxpayer A. The excess of 50 (i.e. the excess foreign profit calculated at 200 - 50) is carried forward to the next year.

¹²³ (100 - 50)/300 * 25% * 300 = 12,5.

¹²⁴ (200 + 50)/300 * 25% * 300 = 62,5.

¹²⁵ See C. van Raad, Fractional Taxation of Multi-State Income of EU Resident Individuals – A Proposal, in: Krister Andersson et al (ed.), Liber Amicorum Sven-Olof Lodin: Modern Issues in the Law of International Taxation - Series on International Taxation v. 27, Kluwer Law International, Den Haag, 2001, p. 211-221. See also C. van Raad, Fractionele

approach could not be introduced for corporate taxpayers (as a CIT functions as a ‘pre-IIIT’; see section 4.1). Notably, in 2001, the Dutch tax legislator adopted the possibility for individuals who are taxed as non-resident taxpayers in the Netherlands to opt for tax treatment as resident taxpayers in the Dutch Individual Income Tax Act.¹²⁶ Non-resident taxpayers opting for resident taxpayer tax treatment are taxed on their worldwide income. The tax exemption is available with respect to their foreign source income. The possibility to opt for this tax treatment under the Dutch tax legislation is only available to taxpayers who have their place of residence within a Member State of the EU or a state with which the Netherlands has concluded a double tax convention. In order to avoid arbitrary outcomes, I think that such a system should not apply by option, but apply *in jure*. EU law seems to require this as well.¹²⁷

On the basis of the reciprocity principle, the application of this system by a State could be limited to situations where a double tax convention or the TFEU applies. In my view, a conceptually sound alternative would be consistent application. In situations where neither a double tax convention nor the TFEU applies, the application of the system may be preceded by a subject to tax clause in combination with a switch over to the (common) ordinary credit for foreign tax method. This would be on the basis of anti-tax abuse considerations.¹²⁸ Taking the principle of administrative convenience into account, the subject to tax clause may, for example, be combined with a rule placing the burden of proof at the level of the taxpayer.

In order for this system to function properly, obligations for taxpayers to provide information on their international business activities, intensive mutual administrative assistance and cooperation between states and legal remedies like international arbitration procedures are of significant importance. In fact, the political willingness to adopt such mutual administrative assistance measures will prove to be a bottleneck for the proper functioning of the proposed system. Nevertheless, in the event that this system would lead to practical problems in assessing corporate tax (e.g. in case practice would show that the relevant information for determining the taxpayer’s tax position is not made available), the solution needs to be sought in improving international administrative assistance (see section 4.4). Illustrative of this is that the Court of Justice does not recognize administrative difficulties (such as a lack of information on the foreign income of taxpayers) as a ground to justify obstacles imposed by EU Member States.¹²⁹ The Court of Justice consistently rejects this argument by pointing out that relevant information can be obtained on the basis of, e.g., the Mutual Assistance Directive.

8 The Court of Justice’s alternative, pragmatic, route to Rome: the territoriality principle

In its case law on the fundamental freedoms in the field of direct taxation, the Court of Justice tries to unify the internal market without internal frontiers and the sovereignty in direct tax matters of the EU Member States. The fiscal sovereignty of the EU Member States cannot conceptually coincide with the concept of the common market without internal frontiers (see section 5). Yet, the

belastingheffing van EU buitenlandse belastingplichtigen, in: *Liberale Gifte (vriendenbundel Ferdinand Grapperhaus)*, Kluwer Deventer 1999, p. 297-305. Cf. Terra, *supra* note 67, at p. 51.

¹²⁶ The tax regime can be found in Article 2.5 of the Dutch Individual Income Tax Act 2001. Note that my interest in this respect is mainly devoted to the mechanism conceptually rather than the distorting manner in which it has been laid down in the current Dutch tax legislation.

¹²⁷ See Renneberg, *supra* note 59.

¹²⁸ Cf. Cadbury, *supra* note 69. Contra Court of Justice, case C-403/03 (Egon Schempp). Contrary to Terra et al, *supra* note 67, at p. 413 and the Court of Justice in the Egon Schempp case, I do not think that market distortions resulting from the application of subject to tax clauses qualify as a disparity. These distortions are caused by obstacles that need to be justified. The subject to tax clause in the German tax regime on cross-border alimony payments tries to make sure that alimony payments in Germany are only tax-deductible when these payments are taxed in the hands of the recipient in the other Member State (i.e. tax deductible item in Germany when income tax is imposed on the other side of the tax border). In other words, the subject to tax clause seeks to counter less than single taxation resulting from the differences between the EU Member States’ tax systems with respect to alimony payments (disparities, i.e. the tax-deduction (payer) and taxation (recipient) of alimony payments in Germany and the non-taxation and non-deduction of these payments abroad). Germany tries to correct this disparity by unilaterally imposing an obstacle. In my view, such an obstacle may be justifiable on the basis of anti-tax abuse considerations.

¹²⁹ See e.g. Swedish A, *supra* note 50 and FII, *supra* note 50.

sovereignty of EU Member States in the field of direct taxation is a given as long as the EU Member States do not transfer their sovereign powers in this field to the EU.

In balancing between the internal market and the EU Member States' sovereignty in direct tax matters, the Court of Justice has developed the so-called territoriality principle.¹³⁰ The Court of Justice (currently) regards territoriality as a ground to justify an obstacle imposed by a Member State. The territoriality principle basically entails that EU Member States are allowed to keep foreign source income items out of their domestic tax base.¹³¹ Accordingly, the Court of Justice recognizes the sovereignty of EU Member States in direct tax matters. However, when expressing the territoriality principle in their international tax systems, the EU Member States are required to do this in a manner that distorts the functioning of the internal market as little as possible (proportionality test). At the end of the day, I would say that EU Member States are required to arrange their tax systems in a manner which ensures that taxpayers can cross the tax borders without being hindered by unilateral tax measures. In other words, changing tax jurisdictions has to be made possible by EU Member States unilaterally in an internally equitable ('market equality principle') and capital neutral ('market neutrality principle') manner.

In this way, the Court of Justice unifies the internal market without internal frontiers with the EU Member States' sovereignty in the field of direct taxation in a pragmatic manner. The Court of Justice's approach is a practical one, as an obstacle that is justified under the territoriality principle conceptually cannot exist. Namely, as soon as the crossing of a Member State's tax border would actually take place in an equitable and tax-neutral fashion (e.g. in a manner as described in section 7.2),¹³² which is a requirement that needs to be met under the proportionality test, there would be no obstacle left. From the perspective of the international tax system of that Member State, the intra-EU business activity would be treated exactly the same as the non-intra-EU business activity. Obstacles would be gone. Distortions within the internal market may then only be caused by a disparity or one of the inadequacies in the 1920s Compromise formula (see section 5).

In my view, the Court of Justice's approach in interpreting the concept of the internal market will ultimately end up with the same outcome as the internal equity / capital neutrality approach (combined with the credit for domestic tax attributable to foreign income) in a globalizing economy. However, unfortunately, as the Court of Justice's case law currently stands, the Court of Justice takes an ambivalent approach when it comes to the interpretation of the proportionality test.¹³³ It is for example unclear how the observations of the Court of Justice in the cases *Renneberg*, *Metallgesellschaft/Hoechst* and *FII*, on the one hand, and the cases *Marks & Spencer II* and *Lidl Belgium*, on the other, relate to each other.¹³⁴ In the cases of *Marks & Spencer II* (base exemption for income from intra-EU business activities of groups of affiliated companies) and *Lidl* (base exemption for income from intra-EU business activities of single corporate taxpayers), the Court of Justice did not have any problems with remaining liquidity disadvantages with respect to non-definitive losses from intra-EU business activities. In these cases, the Court of Justice approved the unilaterally imposed obstacles (i.e. (liquidity)

¹³⁰ Cf. Vanistendael 2008, *supra* note 18, at section 3. Contra Weber, *supra* note 86, at section 3.2.2. For some details on the territoriality principle, see Terra, et al, *supra* note 67, at p. 33.

¹³¹ The Court of Justice has put this into words in *Lidl*, *supra* note 78 as the "need to preserve the allocation of the power to impose taxes between the EU Member States concerned (...) and to prevent the danger that losses may be taken into account twice". Moreover, in *Marks & Spencer II*, *supra* note 20, the Court of Justice referred to a ground for justification founded on anti-tax abuse considerations, i.e. the "risk of tax avoidance". Cf. Court of Justice, cases *Deutsche Shell*, *supra* note 78, *Oy AA*, *supra* note 78 and Court of Justice, case C-157/07 (*Krankenheim*). Other grounds for justification are the need to guarantee the effectiveness of fiscal supervision in situations falling outside the scope of application of the Mutual Assistance Directive (see *Swedish A*, *supra* note 50, *FII*, *supra* note 50) and anti-tax abuse considerations in situations where wholly artificial arrangements are set up with the purposes of "circumventing the application of the legislation of the Member State concerned" (see *Cadbury*, *supra* note 69, *Part Service*, *supra* note 94 and Opinion of A-G Mengozzi in *Columbus*, *supra* note 67).

¹³² As seen from the perspective of that respective Member State's international tax system.

¹³³ See further, Maarten F. de Wilde, *On the Court of Justice's Ambiguous Approach towards the Proportionality Test under the Fundamental Freedoms in the Field of Direct Taxation*, to be published in *EC Tax Review*, as well as M.F. de Wilde, *Over de (on)verenigbaarheid van het fiscale-eenheidsregime met de vestigingsvrijheid*, WFR 2009/1546.

¹³⁴ See respectively *Renneberg*, *supra* note 59, *Metallgesellschaft / Hoechst*, *supra* note 78, *FII*, *supra* note 50, *Marks & Spencer II*, *supra* note 20 and *Lidl*, *supra* note 78. Cf. *Deutsche Shell*, *supra* note 78, *Oy AA*, *supra* note 78 and *Krankenheim*, *supra* note 131.

disadvantages) resulting from the application of a territorial tax system (CIN). As demonstrated in section 6.3.1, these obstacles occur where horizontal loss compensation (compensation of losses realized within a tax year), other than with respect to non-intra-EU business activities, is not allowed with respect to intra-EU business activities. In that event taxpayers operating business activities abroad have to resort to local vertical loss set-off possibilities (compensation of losses realized in another tax year).¹³⁵ Nonetheless, in the cases *Metallgesellschaft* and *FII*, the Court of Justice – in my view appropriately – considered liquidity disadvantages incompatible with the fundamental freedoms.¹³⁶ Moreover, in the *Renneberg* case the Court of Justice – in my view appropriately – ruled that the differences in the Dutch tax treatment of non-resident taxpayers (base exemption/CIN) in comparison with resident taxpayers (tax exemption) are discriminatory.

The inconsistencies in the Court of Justice's case law lead to legal uncertainty. Illustrative are the opposite Opinions of the Dutch Advocate General Wattel, that he delivered within a period of less than a year on the (in)compatibility of the Dutch tax consolidation regime with the freedom of establishment. In July 2007, the Advocate General had some serious doubts as to the compatibility of the regime. However, in September 2008, the Advocate General considered it compatible with EU law due to recent developments in the Court of Justice's case law.¹³⁷

With its ambivalent approach towards the proportionality test, the Court of Justice leaves dislocations in place (*Marks & Spencer II*, *Lidl*), while, at the same time, it dismisses them as discriminatory (*Renneberg*). By acknowledging the base exemption as a proportionate expression of the territoriality principle in the *Marks & Spencer II* and *Lidl* cases, yet refuting it in the *Renneberg* case, the Court of Justice currently takes a somewhat random position with respect to the question whether or not the fundamental freedoms require the international tax systems of the EU Member States to provide taxpayers changing tax jurisdictions with an equitable and neutral tax treatment. Unfortunately, I think that taxpayers crossing the tax border deserve an internally equitable and capital neutral tax treatment. In practice, there is already a double tax relief mechanism available: the 'credit for domestic tax attributable to foreign income'.

9 Concluding remarks

The fiscal sovereignty of states in a globalizing economy leads to market distortions caused by obstacles, disparities and inadequacies in the currently applied formula for allocating tax among taxpayers and between states.

This article addresses the question of how these distortions may be dissolved with respect to the taxation of corporate business income in a global market. When it comes to taxing corporate business income, I think that fairness requires that it should be immaterial for corporate tax purposes where the economic operator has its place of residence. In addition to this, it should be irrelevant whether or not the economic operator performs its business activities in a cross-border context. To date, this has not been achieved. The distortions can only be removed through worldwide harmonization of tax laws in combination with a transfer of fiscal sovereignty to a supranational body. Scholars developed suggestions for a global profit split or a destination-based cash flow tax. The European Commission is currently involved with the CCCTB. However, it is not expected that any of these suggestions will leave the drawing board at any time soon. This is due to the fact that harmonization in the field of direct taxation requires a transfer of sovereignty to a supranational body. And states are (currently) unwilling to do this. Even within the EU.

States are nevertheless able to remove the obstacles they unilaterally impose in their international tax systems. In cases where the TFEU applies, EU Member States can even be forced by the Court of Justice to do this. States impose an obstacle when the domestic tax burden on the income realized out of the cross-border business activities of taxpayers is unequal

¹³⁵ See the Opinion of the Advocate General Wattel, 4 July 2007, V-N 2007/47.16 and HR 11 July 2008, Case C-337/08, V-N 2008/34.14, BNB 2008/305.

¹³⁶ Contra Opinion of Advocate General Sharpston in *Lidl*, *supra* note 78. I think that liquidity disadvantages unilaterally imposed may only be justified on the basis of anti-tax abuse considerations. Cf. *Cadbury*, *supra* note 69.

¹³⁷ See AG Wattel, *supra* note 135 and AG Wattel, *supra* note 81. See also Opinion of AG Kokott of 19 November 2009 in Court of Justice case C-337/08 (*X Holding*) in which she opined that the Dutch tax consolidation regime may generally be regarded as being compatible with the freedom of establishment.

to the domestic tax burden on the income realized out of the non-cross-border (i.e. purely domestic) business activities of taxpayers.

A fundamental step in removing all obstacles in the international tax systems of states is by removing all inequalities in tax treatment between resident and non-resident taxpayers. The combination of internal equity / capital neutrality and the credit for domestic tax attributable to foreign income achieves this. It leads to a system of unlimited tax liability within a taxing jurisdiction which arises as soon as the economic operator is economically present within that taxing jurisdiction. The taxpayer, irrespective of its place of residence, is taxed for the worldwide business income realized. The fiscal sovereignty of states and the principle of single taxation are respected by applying double tax relief with respect to the foreign income through the credit as explained in the above. Tax abuse may be countered with a subject to tax clause in combination with a switch over to the (common) ordinary credit method.

The question of how the approach advocated in this article with respect to the elimination of obstacles should apply to multinational groups of companies has been left untouched. The analysis in this article has been limited to a single entity, taxpayer, operating its foreign business through branches (permanent establishments). In my view, the separate entity approach (under which each separate group company is considered as a single taxpayer) needs to be let go in favour of a unitary business approach. In this respect, one may think of a global tax consolidation, or 'look through' mechanism for corporate tax purposes. This would enable the economic entity, i.e. the MNE, to be treated as the taxable unit. I will explore this scenario in a future article.