What if all EU MSs would subject non-resident taxpayers to unlimited income tax liability while providing for DTR under the Dutch-style 'tax exemption method'?

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1 Introduction

Suppose that all EU Member States ('EU MSs') would be politically willing to turn their direct taxation systems upside down. Suppose that we would decide to start with a clean slate. Suppose that each EU MS would subject all taxpayers – both corporate bodies and individuals – residing for tax purposes within the territories of the European Union ('EU'), which derive income from sources situated within the domestic territories of that respective EU MS, to unlimited tax liability. The worldwide taxation of all EU residents deriving income from domestic sources in each EU MS in which that taxpayer operates economic activities, irrespective of whether these EU residents reside outside or within the territories of the respective taxing EU MS. And suppose that each EU MS would subsequently provide for juridical double tax relief ('DTR') with respect to these EU taxpayers' foreign source income items under the juridical DTR methodology as is currently applied in the Netherlands regarding active income: the 'credit for domestic tax attributable to foreign income'. That is, the application of juridical DTR under the methodology typically referred to in practice as the 'tax exemption with progression method'. Say that each EU MS would adopt such a taxing system.

Indeed, that would be something else. It is commonplace in international taxation to distinguish between non-resident taxpayers who are subject to a limited tax liability, and resident taxpayers who are subject to an unlimited tax liability, while the latter are subsequently in principle eligible to be granted juridical DTR with respect to their foreign source income. What would, regardless, be the effect of adopting such an approach in terms of the tax burdens imposed? The effect would be that the tax burden imposed by each EU MS on proceeds from both domestic and cross-border, i.e., intra-EU, economic activities, consistently is the same. Such an approach may therefore provide a basis for a taxing system without unilaterally imposed distortions of the internal market: a direct taxation system devoid of primary EU law obstacles. In this article I seek to illustrate this effect by means of some numerical examples dealing with cross-border business losses.

2 Distinctive income tax treatment of non-resident taxpayers should be eliminated

On historical grounds, the EU MSs' direct taxation systems typically distinguish between resident taxpayers and non-resident taxpayers. Resident taxpayers, i.e. persons having their place of tax residence *within* the territories of the respective taxing EU MS ('residence state'), are subject to unlimited tax liability and taxed on their worldwide income. In cases where resident taxpayers derive eligible foreign source income items, juridical DTR is subsequently provided. EU MSs promoting an economic policy of capital and labour export neutrality ('CLEN') typically grant DTR by means of an '(ordinary) credit for foreign tax mechanism', or briefly 'credit mechanism'. EU MSs promoting an economic policy of capital and labour import neutrality ('CLIN') typically grant DTR by means of an 'exemption of foreign income from the tax base mechanism', or briefly 'base exemption mechanism'.[2] Non-resident taxpayers, i.e. persons having their place of tax residence *outside* the territories of the respective taxing EU MS ('source state'), are treated differently. These taxpayers are subject to limited tax liability and are taxed on their income to the extent that it is derived from domestic sources. To the extent that non-resident taxpayers derive foreign source income items, these items of income

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[2] Absent a complete harmonization of direct tax systems, an economic policy simultaneously promoting both the import and export of the production factors capital and labour is commonly understood as being impossible to achieve. See Hugh J. Ault and Jacques Sasseville, *Taxation and Non-discrimination: A Reconsideration*, WTJ 2010, Volume 2, No. 2, at section 1. Contra Maarten F. de Wilde, *Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy*, 38 Intertax 281 (2010).

are not included in the source state's tax base. As foreign income is excluded from taxation in the source state, these non-resident taxpayers' foreign source income items are substantially exempt from taxation in the respective source state. Accordingly, 'DTR' is provided in a manner akin to the base exemption as applied by CLIN-promoting residence states in cases involving resident taxpayers having foreign source income. Let us state, for convenience, that by doing so, the source state provides for 'DTR' regarding the non-resident taxpayer's foreign income by means of a 'base exemption mechanism'. It should be mentioned that this approach neatly fits the concepts and principles commonly applied in international taxation. Also the OECD Model Tax Convention shows evidence of embracing this approach.

However, notwithstanding its acceptance in international taxation, non-resident taxpayers are not only subject to different income tax treatment in formal terms, materially they are also subject to a diverging tax burden imposed by the respective taxing EU MS in comparison with resident taxpayers. Compared to resident taxpayers, non-resident taxpayers may be worse or better off depending on the facts and circumstances. On the one hand, non-resident taxpayers are, for example, subject to a more relaxed tax burden in cases involving 'income splits'. The fragmentation of a non-resident taxpayer's tax base, for example directors' fees, across taxing jurisdictions moderates the internationally commonplace progressivity effects in the employed tax rate structures. Viz., rather than on worldwide earnings, non-resident taxpayers are taxed on their income to the extent that it is derived from domestic sources. Mechanisms seeking to appreciate the progressivity effects under the tax rate structures, such as the internationally commonplace tax exemption with progression mechanisms (i.e. a *species* of the *generalis* base exemption), are typically only applied with respect to resident taxpayers (who are subject to unlimited worldwide tax liability). Non-resident taxpayers deriving income from both domestic and foreign sources may benefit from this distinctive tax treatment. On the other hand, non-resident taxpayers may be worse off and be subject to a heavier tax burden imposed in comparison with resident taxpayers. This may for instance be the case where non-resident taxpayers suffer losses from cross-border business activities. Typically, non-resident taxpayers are excluded from the possibility to set-off foreign source losses suffered against the derived domestic source profits while such a 'horizontal' loss set-off possibility is typically available in cases where the items of income would have been derived within the same taxing jurisdiction. Moreover, it is not uncommon that EU MSs (e.g. the Netherlands)[3] enable their resident taxpayers to horizontally set-off foreign source losses against domestic source profits. Non-resident taxpayers suffering losses abroad need to resort to local (i.e. foreign) vertical loss set-off possibilities. As a consequence of that, non-resident taxpayers are put in a disadvantageous tax position (a liquidity disadvantage at best) in comparison with taxpayers who have been allowed to horizontally set-off the losses suffered against the derived profits.[4] Another example of a heavier tax burden imposed to non-resident taxpayers is the imposition of an 'exit tax' (i.e. a latent tax claim on a hidden reserve which immediately becomes due) on non-resident taxpayers upon transfers of property from the respective taxing state's territories to another country.[5] Such an exit tax is typically not levied upon the transfer of property within the territories of that state. Moreover, it is not uncommon for EU MSs (e.g. the Netherlands) to refrain from imposing such an exit tax in cases where resident taxpayers transfer property comprising hidden reserves to another country.[6] Well, that is at least to the extent that these

[3] See for some details, Geert T.W. Janssen & Maarten F. de Wilde, *Key practical issues to eliminate the double taxation of business income; The Netherlands*, to be published as the Netherlands branch report with regard to the 2011 Congress of the International Fiscal Association, at section 2.3. Another EU MS which enables this, if I am not mistaken, is Austria.

[4] See on this matter also Maarten F. de Wilde, *On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test*, 19 EC Tax Review 170 (2010).

[5] A similar matter is currently pending before the Court of Justice. The Amsterdam Court of Appeal requested a preliminary ruling on the (in)compatibility of the Dutch 'exit tax' imposed under the Dutch Corporate Income Tax Act of 1969 upon corporate emigrations. See Amsterdam Court of Appeal (in Dutch: 'Hof Amsterdam'), July 15, 2010, published in the unofficial tax reporter Vakstudienieuws, (hereinafter: 'V-N') 2010/35.6. The European Commission takes the view that the Dutch exit tax infringes primary EU law and decided to refer the Netherlands (together with Denmark and Spain) to the Court of Justice due to their exit tax provisions. See the press release by the European Commission of November 24, 2010, No. IP/10/1565.

[6] In the Netherlands, for example, latent income tax claims on hidden reserves do not become immediately due when resident taxpayers transfer capital assets from Dutch territory to another country. Instead, the hidden reserve is substantially added to the domestic taxable base in yearly installments, which vary in directly proportion to the annual depreciation terms during the remaining economic lifetime of the transferred asset. Technically, the assets

resident taxpayers do not, in conjunction with their property, transfer their tax residence to another as well.

Worth mentioning in this context is the Dutch direct taxation system, which contains a – to my knowledge rather exceptional – mechanism which removes this distinctive tax treatment between resident and non-resident taxpayers. In 2001, the Dutch tax legislator adopted, notably on non-discrimination grounds, the possibility for individuals who are taxed as non-resident taxpayers in the Netherlands to opt for tax treatment as resident taxpayers under Article 2.5 of the Dutch Individual Income Tax Act of 2001 (Dutch IITA 2001).[7] Non-resident taxpayers opting for resident taxpayer tax treatment are taxed on their worldwide income. The general Dutch DTR mechanism often referred to as the 'tax exemption with progression mechanism' (which, in fact, it is not: it operates as a credit; see further sections 5 and 6), is subsequently available with respect to the non-resident taxpayer's foreign source income items. The 'option for resident taxpayer tax treatment' under the Dutch individual income tax legislation is only available to taxpayers (individuals) having their place of residence within an EU MS or a state with which the Netherlands has concluded a double taxation convention ('DTC'). Accordingly, the distinctive, discriminatory, income tax treatment of non-resident taxpayers in comparison with resident taxpayers is resolved by way of an 'opting-in for equal treatment rule'. The mechanism does not apply automatically, i.e., in jure. Accordingly, the distinctive tax treatment still applies in cases where individuals do not opt to be treated equally. In the *Gielen* case, the Court of Justice, in my view on fair grounds, held that the Netherlands cannot justify a discriminatory difference in the tax treatment of non-resident taxpayers by referring to the option to elect for non-discriminatory tax treatment under a specific provision in the Dutch IITA 2001.[8] Discriminatory tax treatment is incompatible with the fundamental freedoms laid down in the Treaty on the Functioning of the European Union ('TFEU') and should therefore be abolished from the Dutch tax system: in jure rather than by option.

The distinctive tax treatment of non-resident taxpayers in comparison with resident taxpayers is founded on a sole ground, i.e., the place of residence for tax purposes. However, the question of whether such an unequal tax treatment should actually be considered to be fair has not often been addressed in the international tax literature.[9] In itself, this may be considered quite remarkable. Namely, one may ask oneself whether this unequal treatment of taxpayers solely based on their place of residence is compatible with the fundamental freedoms in cases falling within the confines of the TFEU. After all, on many occasions, the Court of Justice has ruled that a distinctive tax treatment – in cases where taxpayers make use of their fundamental freedoms – on the basis of that taxpayer's place of tax residence infringes primary EU law.[10] And why would such a distinction which is made upon the establishment of a taxpayer's (un)limited tax liability, as usually found in the first few

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transferred from the Dutch head office to the foreign permanent establishment ('PE') are placed on the PE's balance sheet at fair value rather than the (lower) fiscal bookkeeping value. Subsequently, for the purpose of determining the PE's tax exempt profit, the annual (tax deductible) depreciation term is calculated against that fair value (instead of the fiscal bookkeeping value). Accordingly, this leads to an annual reduction of the tax-exempt PE income for a period that corresponds with the remaining economic lifetime of the respective transferred asset. In addition, this leads to an increase in the corporate tax annually payable at the level of the head office during that same period. See HR, 12 Feb. 1964, published in the unofficial tax reporter 'Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak' ('BNB') 1964/95 (*Hopperzuiger*).

[7] See Article 2.5 Dutch IITA 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.

[8] See Court of Justice, case C-440/08 (*Gielen*).

[9] Exceptions are Frans Vanistendael, *Tax revolution in Europe : the impact of non-discrimination*, 40 European Taxation (3) 2000, Kees Van Raad (who referred to the matter in the context of the income taxation of individuals), in Kees van Raad, *Non-Residents* **–** *Personal Allowances, Deduction of Personal Expenses and Tax Rates*, 2 WTJ 154 (2010), at pp. 154-161, 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, The Hague, 2001, at pp. 211-221, Kees van Raad, *Non-discriminatory income taxation of Non-resident taxpayers by Member States of the European Union: a Proposal*, 26 Brook. J. Int'l L. 1481 (2000-2001), at pp. 1481-1492, as well as De Wilde, *supra note* 2, and De Wilde, *supra note* 4. Notably, Terra and Wattel seem to move in a similar direction as well. See B.J.M Terra and P.J. Wattel, *European Tax Law*, Fifth Edition, Fiscale Studieserie nr. 29, Kluwer Deventer, 2008, at p. 51.

[10] See for instance Court of Justice, cases C-527/06 (*Renneberg*), C-170/05 (*Denkavit Internationaal*), C-307/97 (*Saint Gobain*), C-311/97 (*RBS*) and 270/83 (*Commission v. France*). It should be noted that the Court of Justice has not adopted a consistent line of argumentation in this matter and decided otherwise in cases C-250/95 (*Futura*), C-414/06 (*Lidl*) and C-337/08 (X *Holding*). This is not further discussed. See further, De Wilde, *supra note* 2 and De Wilde, *supra note* 4.

paragraphs of a typical EU MS tax code, escape the EU non-discrimination test? I fail to appreciate why such income tax provisions deserve some kind of special status in this respect. It seems that this unequal tax treatment of non-resident taxpayers solely on the basis of their place of residence survived in international taxation just long enough to become a tenet, true, resting on its own merits, and therefore no longer in need of any discussion with regard to its fairness.

Worthy of note in this respect are the steps taken by the Dutch tax legislator in response to the decision rendered by the Court of Justice in the *Gielen* case.[11] Instead of applying the aforementioned 'option for resident taxpayer tax treatment' in jure, i.e., to all (EU) taxpayers having Dutch sources of income, a response which would have removed all the unilaterally imposed tax obstacles in the current Dutch direct tax system with the stroke of a pen, the Dutch tax legislator decided to merely amend the specific discriminatory element that had been under the scrutiny of the Court of Justice in the *Gielen* case, i.e. the so-called 'working hours test' under the 'self-employed persons' deduction' laid down in the Dutch IITA 2001.[12] Until the decision in the *Gielen* case, this deduction was available for taxpayers, self employed individuals, who worked at least 1,225 hours during the calendar year for the benefit of their business enterprise. The hours worked abroad were eligible, yet exclusively for resident taxpayers. The foreign working hours of non-resident taxpayers were ineligible and, hence, were not taken into account under the 'working hours test' having the effect that non-resident taxpayers faced a higher threshold in obtaining the 'self-employed persons' deduction'. Mr. Gielen, a German resident, and a non-resident taxpayer in the Netherlands, operated business activities in both the Netherlands and Germany. As Mr. Gielen's foreign (German) working hours were not taken into consideration under the 'working hours test', Mr. Gielen found himself not eligible to be granted the 'self-employed persons' deduction'. This left Mr. Gielen subject to a heavier tax burden imposed by the Netherlands in comparison with the scenario of a Dutch resident taxpayer operating business activities in the Netherlands (and Germany). The Court of Justice ruled that this discriminatory tax treatment encroached upon the freedom of establishment and determined that the Dutch 'working hours test' was incompatible with primary EU law. That is, irrespective of the 'option for resident taxpayer tax treatment' available under Article 2.5 Dutch IITA 2001, which's application would have made Mr. Gielen's foreign working hours eligible under the 'working hours test'. As said, the Dutch tax legislator responded by amending the 'working hours test', rather than applying the approach taken under Article 2.5 Dutch IITA 2001 in jure. Accordingly, today, also a non-resident taxpayer's foreign working hours are taken into consideration. In my view, by doing this, the tax legislator did not appreciate that the discriminatory 'working hours test' is just a symptom of an underlying illness in the Dutch tax system: the distinctive tax treatment of non-resident taxpayers (who are subject to limited tax liability) in comparison with resident taxpayers (who are subject to unlimited tax liability). The 'working hours test' is just one of the so many features, here taken as an illustration, of the underlying discrimination issue. If the problem that arose in the *Gielen* case had not been created by the Dutch tax legislator in the first place, i.e., if it did not create the arbitrary difference between resident and non-resident taxpayers in the first paragraphs of the Dutch IITA 2001, Mr. Gielen's foreign working hours would have been automatically eligible under the 'self-employed persons' deduction'. In that event, the discrimination issue would never have occurred. The effect of applying Article 2.5 Dutch IITA 2001 shows proof of this. And a problem that does not arise does not have to be resolved.

Earlier, I argued in Intertax that this distinctive tax treatment entails an unjustified unequal treatment of non-resident taxpayers in comparison with resident taxpayers, which needs to be resolved.[13] In that publication, I advocated taking an approach on the basis of which a tax jurisdiction subjects economic operators economically present within a certain taxing jurisdiction, e.g. foreigners operating business activities in that respective jurisdiction through a permanent establishment ('PE') situated within that jurisdiction's territory, to unlimited tax liability. In addition, I argued that in the event that taxpayers derive income from foreign sources, DTR should be granted on the basis of the methodology I refer to as the 'credit for domestic tax attributable to foreign income', i.e. the DTR mechanisms currently

[11] See the Decree by the State Secretary for Finance (in Dutch: Besluit Staatssecretaris van Financiën) of June 10, 2010, no. DGB2010/2574M, V-N 2010/28.18.

[12] See Article 3.6 Dutch IITA 2001 in conjunction with Article 3.76 Dutch IITA 2001.

[13] See De Wilde, *supra note* 2. See also Maarten F. de Wilde, *A Step towards a Fair Corporate Taxation of Groups In the Emerging Global Market,* 39 Intertax 62 (2011).

found in the 'international tax regime' as the Dutch-style 'tax exemption' mechanism.[14] For a detailed analysis, reference is made to the aforementioned article.

At first glance, such an approach may be considered to be somewhat 'round the bend'. Or, at least, strongly counterintuitive. Yet, the required thought process is less substantial than it seems. The approach is already present within the international tax regime. Viz., under Article 2.5 of the Dutch IITA 2001, non-resident taxpayers, individuals, may opt (on non-discrimination grounds!) for resident taxpayer tax treatment, i.e. to be subject to unlimited tax liability and taxed on their worldwide income while DTR is provided under the Dutch style 'tax exemption' mechanism. The next step in the thought process is si,mly to appreciate the approach taken on an autonomous basis, i.e., outside the context of the Netherlands' individual income tax system, the notion of its application in jure, and the notion of adopting it in corporate taxation as well.

Moreover, worth mentioning is the presence of an indirect tax in the 'tax mix', i.e., at least within the context of the EU, which does not distinguish between resident and non-resident taxpayers at all: the value added tax ('VAT'). Under the EU-style VAT, the taxpayer is 'any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity.'[15] Actual VAT becomes due within a certain EU MS subsequently when goods or services are supplied within the territory of that EU MS. As this European consumption tax does not distinguish between taxpayers on the basis of their place of residence, no discrimination issues arise as a consequence of that. Accordingly, the VAT lacks the discrimination issues as often recognized in direct taxation. I do not believe this to be a coincidence.

3 A basis for an 'obstacle-free' state international tax system

Such an amendment in the approach taken towards the imposition of direct taxes in the EU would cancel out the distortive distinction as currently made by EU MS between resident and non-resident taxpayers. First, in the event that taxpayers (i.e. both resident *and* non-residents), deriving income from domestic sources, are subject to unlimited tax liability, as is exclusively the case with resident taxpayers today, the current indirect discriminatory tax treatment would cease to exist (i.e., the EU market equality principle is appreciated). Second, in the event that, subsequently, DTR is provided regarding taxpayers deriving foreign source income under the methodology I refer to as the 'credit for domestic income tax attributable to foreign income', the tax burden imposed by that EU MS on proceeds from both domestic and cross-border (i.e., intra-EU) economic activities would consistently be the same (i.e., the EU market access principle is appreciated).[16] Contrary to, for example, the base exemption for foreign source income – which eliminates the progressivity in the current tax rate structures, entails the imposition of 'exit taxes' on property transfers across tax borders, and eliminates horizontal loss set-off possibilities – the application of the aforementioned credit mechanism would entail an unhindered tax border crossing within the internal market. Viz., such an approach would provide a basis for an EU MS international tax system[17] without obstacles being imposed, in other words an 'obstacle-free', or 'EU-fundamental freedom-proof' EU MS international tax system.

Preliminary questions to the Court of Justice on the interpretation of the fundamental freedoms in cases falling within the confines of the TEU may then become a thing of the past. Namely, the domestic tax burden imposed on all proceeds from taxpayers' intra-EU economic activities, i.e. both cross-border and non-cross-border, would be the same. The tax burden would be the same irrespective of the taxpayer's place of residence and irrespective of the question of whether that taxpayer operates its economic activities in a cross-tax border (intra-

[14] With the term 'international tax regime' I mean the international tax legal order created, comprising of the aggregate of states' international tax systems, which in turn are each comprised of their domestic tax system, their DTC network, and the supranational European Union law framework, i.e. the latter to the extent that it concerns EU Member States in cases falling within the confines of the TFEU. See for a comparison Reuven S. Avi-Yonah, *Tax Competition, Tax Arbitrage and the International Tax Regime*, 61 Bulletin for International Taxation 130 (2007), at p. 131. See also Reuven S. Avi-Yonah, *International Tax as International Law; An Analysis of the International Tax Regime*, Cambridge University Press, New York, 2007, at Chapters 1 and 10.

[15] See Article 9, first indent, VAT Directive.

[16] This would not be the outcome in cases where DTR is provided under the base exemption mechanism (CLIN) or (ordinary) credit mechanism (CLEN). See further De Wilde, *supra note* 2, at section 6.3.

[17] Notably, with the wording 'international tax system' I refer to the combination of an EU MS' domestic tax system and DTC network.

EU) context. And, as I understand, this is exactly what the envisaged internal market without internal frontiers calls for (subject to the recognition of EU MS sovereignty in the field of direct taxation).[18] Hence, an approach as advocated here would provide for the desired equilibrium between the tax sovereignty of the EU MSs and the internal market without internal frontiers.[19]

4 The approach's effects illustrated using numerical examples

How does the approach advocated here operate? In the following sections, I illustrate its effects by means of numerical examples. For that purpose, I limit myself to addressing the effects on losses suffered from cross-border business activities. Moreover, I assume that the facts of the case fall within the scope of application of the TFEU. I do not refer to the Court of Justice's inconsistent lines of argumentation in its case law. Unfortunately, due to the inconsistencies in the Court's reasoning, I find it unfeasible to draw normative conclusions from its case law (in se). In my view, this has called for an autonomous analysis on the basis of the underlying notions of the internal market.[20] In addition, I do not address potential legal-technical complications under the currently applicable sources of international tax law. From an EU law perspective, DTCs are not that relevant. Or at least, their relevance should not be exaggerated as it does not go beyond the relevance of the EU MSs' domestic tax frameworks. Supranational EU law takes precedence over the entire EU MSs' international tax systems, i.e. both their domestic tax systems and DTC networks.[21] Both need to operate in accordance with supranational EU law. Hence, complications of a legal-technical nature in this area should simply be resolved. At the end of the day, seen from an EU law perspective, these issues are merely of a technical nature. Moreover, the application of anti-abuse measures, such as a 'switch-over to ordinary credit (for foreign tax) mechanisms', in cases where taxpayers seek to transfer volatile production factors to low-taxing jurisdictions are not addressed. Finally, potential administrative complications are not addressed either. I merely focus on the approach's operation in terms of tax burdens imposed.

In section 5, I address the Dutch-style DTR mechanism's current operation under a default scenario, the 'Base case'. Subsequently, in section 6, I address the overall effects under the advocated approach – i.e., the approach as advocated in this article being 'unlimited tax liability of individuals and corporate entities with domestic sources of income and DTR under the Dutch-style 'tax exemption' mechanism' – in terms of tax burdens imposed in a cross-border (intra-EU) context. While doing that, the assumption is made that both EU MSs adopt the exact same methodology at both sides of the tax border. The reason for this is the following. Only when mutual divergences between the respective EU MSs international tax systems (i.e., disparities[22]) are hypothesized to be terminated, it is feasible to isolate the obstacles imposed unilaterally by the respectively scrutinized EU MS's international tax system. The purpose of such a thought experiment within the context of this article is to illustrate that the approach as advocated above entails an imposition of equal tax burdens in both domestic and cross-border scenarios in cases where losses have been suffered from cross-tax border business activities. And, accordingly, to illustrate that the crossing of a tax border in that event does not affect the tax burden whatsoever. In sum, the purpose of the exercise is to illustrate that the transfers of tax residence or production factors across tax borders would not result in unilaterally imposed obstacles distorting the envisaged neutral and equitable operation of the internal market without internal frontiers. Viz., if the tax burden would alter upon such a transfer under the thought experiment, this would prove the unilateral distortive effects of the tested system. This would illustrate the presence of an

[18] See De Wilde, *supra note* 4, at section 2.

[19] Contra Weber in D.M. Weber, *In Search of a (New) Equilibrium between Tax Sovereignty and the Freedom of Movement within the EC*, Deventer, Kluwer, 2006, at p 11–18. Weber shows evidence of favouring a CLIN-promoting territorial system. By pointing at the Court of Justice's ruling in case C-250/95 (*Futura*), Weber argues that unilaterally imposed market distortions resulting from EU Member States expressing the territoriality principle in their international tax systems are disparities. In my view, such an approach does not provide for unilateral tax neutrality. See De Wilde, *supra note* 2, at section 6.3.

[20] See for a comparison De Wilde, supra note 4, at section 5.

[21] See e.g., Court of Justice, cases 26/62 (*Van Gend & Loos*) and 6/64 (*Costa/ENEL*). Moreover, see, e.g., Court of Justice case C-265/04 (*Bouanich*).

[22] With disparities I mean the mutual divergences between international tax systems in terms of 'who is taxed' (the taxpayer), 'what is taxed' (the tax base) and 'at which tax rate is taxed' (the tax rate), as well as mutual divergences in terms of applied international taxing principles (nationality, situs, domicile).

obstacle. Hence, the thought experiment may also be worth exercising for the purpose of illustrating the absence of a distortive feature.

5 The operation of the Dutch DTR mechanism in cases of cross-border losses

5.1 The Dutch DTR mechanism's operation in general

The DTR mechanism for active income from foreign sources as currently applied in the Netherlands is commonly referred to in the international tax literature as the 'tax exemption with progression method'.[23] Commonly, the Dutch DTR mechanism is explained in international tax literature as a base exemption mechanism with respect to which "the foreign source income is initially included in the taxpayer's income for the limited purpose of determining the average tax rate at which that taxpayer would pay if the foreign income were taxable". Subsequently, it is generally said that the "average rate is then used to compute the actual tax due on the taxpayer's domestic source income". This, unfortunately, is a mistaken description of the Dutch juridical DTR mechanism. Also the Court of Justice shows evidence, e.g., in the *X Holding* case, that it does not fully appreciate the mechanism's operation.[24] It does not function in such a manner as it does not exempt foreign source income from the tax base. The DTR mechanism simply does not operate as a base exemption.

Conceptually, despite the commonly applied reference to the wording 'tax exemption' – which, notably, is also the terminology as referred to under its clouded Dutch name 'belastingvrijstelling', a term that literally translates into English as 'tax exemption' presumably thereby triggering the confusion –, the DTR mechanism operates as a credit.[25] Even in Dutch tax literature the term exemption is employed, typically without the mechanism being recognized as a credit. However, contrary to tax credit mechanisms as commonly applied in international taxation, it is not the tax levied abroad that is credited against the domestic tax imposed on the foreign income. It is a credit of the Dutch (individual/corporate) income tax that is attributable to the foreign source income items. Accordingly, the DTR is calculated without taking the foreign tax burden into account.

Under the DTCs concluded, the Netherlands reserves the right to include foreign source income items (both positive and negative) in the domestic tax base ('tax base reservation' or in Dutch: 'grondslagvoorbehoud') for the purpose of taxing Dutch resident taxpayers. Accordingly, first, foreign source income items are included in the resident taxpayer's worldwide tax base. Subsequently, second, DTR is provided with respect to the foreign source income items that have been included in the Dutch worldwide tax base under Dutch tax law ('tax base requirement', in Dutch: 'grondslageis'). The mechanism applied, as said, is conceptually a credit for domestic tax attributable to the foreign income. In its operation, the methodology works in a manner akin to the second limitation as commonly applied in international taxation under an ordinary credit mechanism. However, in this case, the second limitation operates on a stand-alone basis, i.e., without making reference to foreign taxes levied (as is typically the case under the first limitation in the ordinary credit mechanisms). The Dutch tax payable is subsequently determined by crediting the Dutch tax that is attributable to the foreign source income items against the Dutch tax as calculated by making reference to the respective taxpayer's worldwide income.

The functioning of the double tax relief methodology can be best explained through some numerical examples. Year 1: 'Base case'. The business income of a Dutch resident taxpayer 'Ben Johnson (Horticultural Retail Company)', hereinafter: 'Johnson', from its Dutch source a), for instance a branch situated within Dutch territory, adds up to € 140,000 (positive). Johnson's business income from foreign source b), for instance a branch situated in EU MS X, for instance Belgium, adds up to € 60,000 (positive). Now let us assume that Johnson, thereby, derives business income in Belgium through a PE situated within Belgian territory, the territorial allocation of business income occurs in accordance with OECD concepts and principles and Johnson is eligible to be granted DTR under the Dutch-style DTR

[23] See Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, Second Edition, Kluwer Law International, The Hague / New York, 2002, at pp. 33-34.
[24] See Court of Justice case C-337/08 (*X Holding*) and the comments thereon by D.M. Weber, *Refusal of advantages of a cross-border tax consolidation in some situations an unjustified restriction of the freedom of establishment*, Highlights and Insights on European Taxation 2010/1.6. See also De Wilde, supra note 4.
[25] See for some details, Janssen et al., *supra note* 3, at sections 1 and 2.

methodology for active foreign source income. Johnson's worldwide income equals € 200,000. In figures (before tax):

Fig. 1. Balance Sheet "branch a)" on 1/1 (i.e. start of tax bookkeeping period)

Balance Sheet "branch a)" on 1/1			
Debit		*Credit*	
Assets	€ 3,000,000	Equity Liabilities	€ 2,000,000 € 1,000,000
On balance	€ 3,000,000	On balance	€ 3,000,000

Fig. 2. P&L-account "branch a)" 1/1 – 12/31

P&L-account "branch a)" 1/1 – 12/31			
Debit		*Credit*	
Expenses **Profit before tax**	€ 160,000 **€ 140,000**	Receipts	€ 300,000
On balance	€ 300,000	On balance	€ 300,000

Fig. 3. Balance Sheet "branch a)" on 12/31 (i.e. end of tax bookkeeping period)

Balance Sheet "branch a)" on 12/31			
Debit		*Credit*	
Assets	€ 3,140,000	Equity Liabilities	€ 2,140,000 € 1,000,000
On balance	€ 3,140,000	On balance	€ 3,140,000

Fig. 4. Balance Sheet "branch b)" on 1/1

Balance Sheet "branch b)" on 1/1			
Debit		*Credit*	
Assets	€ 1,500,000	Equity Liabilities	€ 1,000,000 € 500,000
On balance	€ 1,500,000	On balance	€ 1,500,000

Fig. 5. P&L-account "branch b)" 1/1 – 12/31

P&L-account "branch b)" on 1/1 – 12/31			
Debit		*Credit*	
Expenses **Profit before tax**	€ 100,000 **€ 60,000**	Receipts	€ 160,000
On balance	€ 160,000	On balance	€ 160,000

Fig. 6. Balance Sheet "branch b)" on 12/31

Balance Sheet "branch b)" on 12/31			
Debit		*Credit*	
Assets	€ 1,560,000	Equity Liabilities	€ 1,060,000 € 500,000
On balance	€ 1,560,000	On balance	€ 1,560,000

In addition, suppose that the income tax rate in Belgium equals a linear 18%. Suppose that the Netherlands applies a progressive tax rate in its profit tax system. And suppose that the tax brackets are arranged as follows:

Fig. 7. Tax Brackets

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

As said, Johnson's tax liability is determined in two steps. First, the Dutch tax on Johnson's worldwide income is calculated. The Dutch tax on Johnson's worldwide income amounts to € 5,000[26] + € 10,000[27] + € 25,000[28] = € 40,000. Second, the DTR is calculated by

[26] 10% * 50,000.
[27] 20% * 50,000.
[28] 25% * 100,000.

making reference to the Dutch tax that is attributable to Johnson's foreign income (thereby appreciating the functionally separate entity approach found in the respectively applicable DTC's equivalent of Article 7 OECD Model Tax Convention). For the purpose of calculating the DTR, the following fraction is applied: *(foreign income / worldwide income) * Dutch tax on worldwide income*. In the example, accordingly, the application of the fraction leads to DTR amounting to € 12,000.[29] The Dutch tax payable is accordingly set at € 40,000 - € 12,000 = € 28,000, an effective tax rate in the Netherlands of 20% on the Dutch share of the international tax pie (i.e., € 140,000). In this way, the progressivity in the Dutch tax rate structure is respected (which explains the element 'with progression' in the DTR mechanism's wording).[30] Please note that the amount of Belgian tax payable (€ 10,800[31]) with respect to Johnson's foreign income of € 60,000 is ignored for the purpose of calculating the DTR in the Netherlands.[32]

5.2 Cross-border loss set-off

5.2.1 The 'recapture of foreign losses' and the 'carry forward of foreign profits'

As a consequence of adopting the 'tax base reservation', the Netherlands allows its resident taxpayers to include negative income items from foreign sources in the domestic tax base. Hence, the Netherlands allows resident taxpayers to horizontally set-off foreign source losses/profits against domestic source profits/losses. In the case of resident taxpayers suffering foreign or domestic source losses, single taxation on cross-border business income is subsequently achieved through the application of the so-called 'recapture of foreign losses mechanism' (in Dutch: 'inhaalregeling') and the 'carry forward of foreign profits mechanism' (in Dutch: 'doorschuifregeling'). The single tax principle is thereby appreciated, an effect of the Dutch DTR mechanism that the Court of Justice, unfortunately, failed to appreciate to its full extent in the *X Holding* case.[33] Again, these mechanisms are best explained by way of numerical examples.

5.2.2 The recapture of foreign losses mechanism

Suppose that, all other things being equal to the 'Base case', the Dutch resident taxpayer Johnson suffers a loss from its activities carried on through its branch b) in Belgium adding up to € 60,000 in year 1. Since the foreign loss is taken into account for the purpose of calculating the Dutch tax base (horizontal loss compensation), Johnson's taxable base amounts to € 80,000.[34] As a result of this, the Dutch tax payable amounts to € 11,000 (i.e.

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[29] 60,000 / 200,000 * 40,000.

[30] The application of a (distorting) base exemption for foreign income (CLIN) would lead a tax payable of € 25,000 (10% * 50,000 + 20% * 50,000 + 25% * 40,000). This would lead to a 'dislocation' (or more accurately put: unjustified unequal treatment by the Netherlands as the state of origin) favouring Johnson in comparison with its competitors that decided to stay at home and not to take their business across the tax borders. This is due to the income split. The unilaterally imposed tax benefit for Johnson would amount to € 3,000 (28,000 – 25,000). This example illustrates the absence of tax (in this case export) neutrality under a CLIN promoting territorial tax system. CLIN distorts outbound investments.

[31] 18% * 60,000.

[32] The application of a (distorting) ordinary credit for foreign tax (CLEN) would lead to a payable tax of € 29,200 (€ 40,000 – 10,800). This would lead to a competitive disadvantage for taxpayer Johnson in Belgium in comparison with Johnson's local competitors who are merely subject to the 18% linear tax rate (Johnson being discriminated against by the Netherlands as the state of origin). The unilaterally imposed tax disadvantage would amount to € 1,200 (€ 29,200 - € 28,000). In order to derive an equal amount of after-tax profits, Johnson would need to increase the prices for his flowers sold in Belgium. That might cause Johnson to rapidly run out of business. Knowing this, Johnson, may even consider not to engage into business activities in Belgium in the first place. This example illustrates the absence of tax (in this case import) neutrality under a CLEN-promoting credit system This exactly illustrates the distortive features of CLEN which brought Klaus Vogel to argue that the adoption of a CLEN-based taxing system entails the adoption of unilaterally imposed obstacles. See Klaus Vogel, *Which Method Should the European Community Adopt for the Avoidance of Double Taxation?*, 56 Bulletin for International Taxation 4 (2002). CLEN distorts inbound investments.

[33] See Court of Justice case C-337/08 (*X Holding*) in which the court, unfortunately mistakenly, recognized double dip risks and arbitrary shifting of tax bases across taxing jurisdictions under the application of the Dutch juridical DTR methodology. See for comments on the court's ruling in the *X Holding* case, Weber, *supra note* 24 and De Wilde, *supra note 4*.

[34] 140,000 – 60,000.

5,000 + 6,000).[35] There will be no double tax relief provided that year, as taxpayer Johnson suffered a loss abroad. Alternatively, Johnson receives an administrative notice from the tax inspectorate that the loss of € 60,000 is recaptured as soon as Johnson manages to derive positive income from its Belgian branch b) in a following year.

Now suppose that, in year 2, taxpayer Johnson manages to derive a profit from of its activities carried on through its Belgian branch b) of € 80,000, all other things being equal to the 'Base case'. In year 2, Johnson's worldwide income is consequently € 220,000.[36] As said, the double tax relief is determined in two steps. First, the Dutch tax on Johnson's worldwide income is calculated at € 5,000 + € 10,000 + € 30,000[37] = € 45,000. Second, the double tax relief is determined. The year 1 loss of € 60,000 is recaptured in year 2 under the 'recapture of foreign losses mechanism'. Technically, this entails that the numerator in the fraction decreases by 60,000 to 20,000 (i.e. 80,000 – 60,000). The reduction of the numerator in the fraction leads to a reduction of the double tax relief provided (and with that an increase in tax payable in the Netherlands). The DTR provided for in year 2 amounts to € 4,090.91[38] The Dutch tax payable in year 2 is accordingly set at € 40,909.09.[39]

This ensures that the year 1 loss is tax-deductible when actually suffered, yet only taken into account once (instead of twice). Single taxation has been guaranteed as well. The single tax principle is thereby respected. Belgian sovereign tax entitlements regarding the Belgian source income items are appreciated. Belgian tax implications (e.g. availability of local loss set-off possibilities) are ignored. But then again, this is a Belgian sovereign tax matter.

5.2.3 The carry forward of foreign profits mechanism

Suppose that, all other things being equal to the 'Base case', the Dutch resident taxpayer Johnson suffers a loss from its activities carried on through its branch a) in the Netherlands adding up to € 140,000 in year 1. As this domestic loss is taken into account for the purpose of calculating the domestic tax base (i.e. 'horizontal loss compensation'), Johnson's taxable base consequently amounts to € 80,000 negative.[40] As a result of this, the Dutch tax payable amounts to nil. There will be no DTR provided (e.g. through a cash refund) as the tax payable in the Netherlands is already nil. Contrary to, for instance, the EU-style VAT, cash refunds are unavailable. Alternatively, Johnson receives an administrative notice from the tax inspectorate that the foreign profit of € 60,000 is carried forward to a following year in which Johnson manages to derive positive income from its activities carried on through its domestic branch a).

Now suppose that, in year 2, taxpayer Johnson realizes a profit out of its domestic source a) of € 200,000, all other things being equal to the 'Base case'. In year 2, Johnson's worldwide income is consequently € 260,000.[41] Again, the DTR is determined in two steps. First, the Dutch tax on Johnson's worldwide income is calculated at € 5,000 + € 10,000 + € 40,000[42] = € 55,000. Second, the amount of DTR is calculated. The year 1 profit of € 60,000 derived from the activities carried on through branch b) in Belgium is carried forward to year 2 under the 'carry forward of foreign profits mechanism'. Technically, this entails that the numerator in the fraction increases by 60,000 to 120,000 (i.e. 60,000 + 60,000). The increase in the numerator in the fraction leads to an increase of double tax relief provided that year

[35] 5,000 + 20% * 30,000. The application of a (distorting) base exemption for foreign income (CLIN) would lead to a payable Dutch tax of € 25,000 (10% * 50,000 + 20% * 50,000 + 25% * 40,000) on an income of € 140,000. This would lead to a 'dislocation' disfavouring taxpayer Johnson in comparison with his competitors that decided to stay at home and not to take their business across the tax borders. This would be caused by the then non-deductibility of the negative income items realized through the Belgian branch b). The unilaterally imposed tax disadvantage would equal € 14,000 (25,000 – 11,000), an increase of the tax burden at a factor of roughly 2,28 (2,28 * 11,000 ≈ 25,000). Also this example shows the absence of tax (in this case export) neutrality under a CLIN-promoting territorial tax system. CLIN distorts outbound investments.

[36] 140,000 + 80,000.

[37] 25% * 120,000.

[38] (80,000 - 60,000) / 220,000 * 45,000.

[39] 45,000 - 4,090.

[40] 60,000 - 140,000.

[41] 200,000 + 60,000.

[42] 25% * 160,000.

(and with that a decrease in tax payable in the Netherlands). The DTR provided for in year 2 amounts to € 25,384.62.[43] The Dutch tax payable in year 2 is accordingly set at € 29,615.38.[44]

This mechanism ensures that the year 1 profit realized abroad does not diminish for DTR purposes but, instead, is taken into account as a profit eligible for DTR in year 2. Accordingly, Johnson's profits are taken into account once (rather than not at all). Single taxation is guaranteed. Again, the sovereign tax entitlements of Belgium regarding the proceeds derived from the business activities carried on through branch b) are respected. Belgian tax implications are ignored.

6 *The operation of the advocated system*

What would be the effect in the event that EU MSs' non-resident taxpayers would also be subject to the aforementioned tax treatment, just like Dutch resident taxpayers currently are? Suppose that taxpayer Johnson would be entitled to this tax treatment if he would have resided in any EU MS other than the Netherlands. Currently, this is not the case. As said, under Dutch tax law, taxpayers (both individuals and companies) are only eligible to be granted the aforementioned tax treatment in the Netherlands if they reside within Dutch territory (save for the exception laid down in Article 2.5 Dutch IITA 2001 on the basis of which non-resident taxpayers/individuals may opt to be treated equal to resident taxpayers). Foreign income items of non-resident taxpayers are excluded, or 'exempt' so to say, from the Dutch tax base. Consequently, negative income items from foreign sources are not tax deductible. If Johnson would have resided for instance in Brussels or Rome for Dutch tax purposes, it would have been impossible for him to deduct the Belgian source losses from its Dutch tax base, solely because of its tax residency in Belgium or Italy. And, as also said, the Netherlands does not stand alone in this respect. To my knowledge, all EU MSs subject non-resident taxpayers to this distinctive tax treatment entailing the abovementioned consequences of foreign losses being non-deductible. That is plainly indirectly discriminatory, which the Court of Justice, for instance in the *Renneberg* case, in my view fairly, considers to infringe primary EU law.[45] Notably, in my view, it does not make any difference conceptually that the Renneberg case (coincidentally) dealt with a Belgian resident individual who, by reason of his fiscal domicile, was ineligible to be granted the Dutch tax subsidy for his Belgian private dwelling. Where it concerns the interpretation of the fundamental freedoms, the Court of Justice is not a tax court. Rather, it may be characterized as a constitutional court scrutinizing the legal implications in the EU MSs of undertaking (economic) activities in an intra-EU, cross-border context, against the EU equality principle. Notably, I fail to appreciate why it should make a difference in direct tax-related cases that the taxpayer involved is a private individual or a corporate body having legal personality. Moreover, the question of whether the non-deductibility of certain expenditures due to the taxpayers' tax residency abroad involves a 'tax subsidy' also seems irrelevant to me. At the end of the day, all that matters is the application of the equality principle. Are economically equal circumstances being treated unequally by EU MSs for tax purposes (or vice versa)? If yes, such a difference in tax treatment (in cases falling within the confines of the TEU) encroaches upon the fundamental freedoms where the differences in tax treatment entail differences in the tax burdens imposed. And this, currently, is the case in all EU MSs.

Again, what would be the outcome under the aforementioned approach in terms of tax burdens imposed – when applied consistently on both sides of the respectively involved EU MSs' tax borders –, thus regarding all EU residents having domestic (and foreign) sources of income? Let us exercise the thought experiment. Suppose that disparities are absent. All EU MSs involved adopt the same approaches towards the taxable unit, the tax base and the tax rate. Moreover, the international tax principles are adopted coherently as well. Suppose that both Belgium and the Netherlands apply the advocated approach.

The outcome would be that the tax burden imposed is exactly the same in both domestic and cross-border scenarios, i.e. regarding all proceeds derived from intra-EU economic activities. It would become immaterial in which EU MS Johnson resides. It would also become immaterial whether (or not) Johnson operates its commercial activities in an

[43] (60,000 + 60,000) / 260,000 * 55,000.
[44] 55,000 – 25,384.62.
[45] See Court of Justice, case C-527/06 (*Renneberg*).

intra-EU cross-border context. The tax burden imposed would remain the same. The crossing of tax borders within the EU's internal market would not be hindered whatsoever.

Things are best illustrated by referring to the tax position of Johnson in the 'Base case' and its variations as put forward in the previous section. That is, under the additional assumption that the same approach is adopted on both sides of the Belgian-Dutch tax border. Then, it becomes evident that the mutual operation of the 'recapture of foreign losses' and 'carry forward of foreign profits' mechanisms operate as interconnected tanks. Where one EU MS applies the recapture, the other EU MS applies the carry forward. And vice versa. Thus, Johnson (the place of residence is now irrelevant for tax purposes), now subject to unlimited tax liability, still operates its flower trading activities through branches a) and b). In year 1, Johnson suffers losses as referred to in section 5.2.2. The loss suffered from the activities carried on through branch b) equal € 60,000. In year 2, taxpayer Johnson, again similar to the scenario in 5.2.2., manages to derive a profit from its branch b) of € 80,000.

The effect may be best demonstrated by using tables. *Figure 8. 'domestic scenario – loss set-off'* deals with the case that both taxpayer Johnson's branches of activities are situated within the territories of one EU MSs say the Netherlands. *Figure 9. 'cross-border scenario – cross-border loss set-off'* deals with the case where taxpayer Johnson's branches a) and b) are situated across the territories of different EU MSs. Say, branch a) is situated in the Netherlands and branch b) is situated in Belgium.

Fig. 8. 'domestic scenario – loss set-off'

Taxpayer Johnson	**Year 1**
Income branch a) in NL	140,000
Income branch b) in NL	<60,000>
On balance	**80,000**
Tax due in NL (under brackets as in 5.1)	**11,000**
Tax burden imposed by NL	**13.8%**

Taxpayer Johnson	**Year 2**
Income branch a) in NL	140,000
Income branch b) in NL	80,000
On balance	**220,000**
Tax due in NL (under brackets as in 6.1)	**45,000**
Tax burden imposed by NL	**20.5%**

Fig. 9. 'cross-border scenario – cross-border loss set-off'

Taxpayer Johnson (Year 1)	**Domestic income**	**Worldwide income**	**Income tax before double tax relief**	**Credit for domestic tax attributable to foreign income**	**Recapture foreign losses (admin. notice)**	**Carry forward foreign profits (admin. notice)**	**Income tax after double tax relief**	**Tax burden after double tax relief**
Tax position in NL	140,000	80,000	11,000	0	60,000	0	11,000 *(i.e. tax due in NL)*	n/a
Tax position in Belgium	<60,000>	80,000	11,000	11,000[46]	0[47]	60,000	0 *(i.e. tax due In Belgium)*	n/a
On balance	**80,000**	80,000	11,000	n/a	n/a	n/a	**11,000** *(i.e. overall corporate tax due)*	**13.8%**[48] *(i.e. overall tax burden imposed*)

Taxpayer Johnson (Year 2)	**Domestic income**	**Worldwide income**	**Income tax before double tax relief**	**Credit for domestic tax attributable to foreign income**	**Recapture foreign losses**	**Carry forward foreign profits**	**Income tax after double tax relief**	**Tax burden after double tax relief**

[46] 80,000 / 80,000 * 11,000. The fraction is maximized at 1 (80,000/80,000 instead of 140,000 / 80,000) as State B would otherwise refund the tax in cash to taxpayer Z. The excess of 60,000 (i.e. the excess foreign profit calculated at 140,000 – 80,000) is carried forward to the next year under the carry forward of foreign profits mechanism.

[47] 11,000 – 11,0000 = 0

[48] 11,000 / 80,000 * 100% = 13.8%

Tax position in NL	140,000	220,000	45,000	4,090.91[49]	0	0	40,909.09[50] *(i.e. tax due in NL)*	n/a
Tax position in Belgium	80,000	220,000	45,000	40,909.09[51]	0	0	4,090.91[52] *(i.e. tax due in Belgium)*	n/a
On balance	**220,000**	220,000	45,000	n/a	n/a	n/a	**45,000** *(i.e. overall corporate tax due)*	**20.5%[53]** *(i.e. overall tax burden imposed)*

As illustrated in the above tables, the tax burden imposed on taxpayer Johnson's income is identical in both the domestic (solely Dutch) and cross-border (intra-EU, i.e. in this case the Belgian-Dutch) scenario under the advocated approach. In both scenarios the tax due would equal € 11,000 in year 1 and € 45,000 in year 2. The effective tax rates in both domestic and cross-border scenarios are identical as well, i.e., 13.8% in year 1 and 20.5% in year 2. Accordingly, under the assumed circumstances, i.e., the absence of disparities, it now is completely irrelevant in which EU MS taxpayer Johnson has its place of residence for tax purposes. Johnson may emigrate to whichever EU MS, e.g., Spain, Italy, Denmark, et cetera, he chooses. The tax burden imposed, in this case by the Netherlands and Belgium, would not alter as a consequence. It is also now irrelevant whether Johnson performs its business activities solely in one EU MS, in this case the Netherlands or that it is spread across various EU MSs, in this case the Netherlands and Belgium. Johnson may decide to open a(nother) flower trading business in any other EU MS without the consequence of losing horizontal loss set-off entitlements. Taxing principles are distributed equitably. Hence, Johnson – to the extent that it concerns the imposition of income taxation – can move unhindered between the EU MSs' national markets. At least, to the extent it concerns the matter of cross-border loss compensation. This outcome coincides with the envisaged elimination of unilaterally imposed tax obstacles within the internal market without internal frontiers. To that end, fair (equitable, i.e. non-discriminatory) and free (economically efficient, i.e., tax neutral) competition within the internal market would be enabled.[54] Viz., the changing of tax jurisdictions would not alter the tax burden imposed. Movements of economic operators/taxpayers and their operations/production factors/sources of income within the internal market are therefore not influenced/distorted. This seems tax neutral to me. Interestingly, this holds true with respect to both the inward-bound movements ('import') and outward-bound movements ('export') of the production factors capital and labour. The advocated approach hence simultaneously promotes both capital and labour import neutrality ('CLIN') and capital and labour export neutrality ('CLEN').

7 *But not all distortions of the internal market would be resolved…*

It needs to be rehashed that the aforementioned numerical examples are based on the assumption that both the Netherlands and Belgium operate the exact same international tax system. Accordingly, it is assumed that disparities do not exist. Obviously, however, this is untrue in the real world. Disparities between the (currently 27) EU MSs' international tax systems can and do exist. All EU MSs operate their own system and employ a variety of mutually diverging approaches towards the recognition of the taxable unit, the calculation of the taxable base, the applied tax rate and the international tax principles upon which they mutually distribute taxing entitlements. These disparities result in distortions in the functioning of the internal market. From in internal market perspective, this is undesirable. Nevertheless, these distortions will remain in place as long as further harmonisation measures within the EU, such as the envisaged Common Consolidated Corporate Tax Base (and the necessary

[49] (80,000 – 60,000) / 220,000 * 45,000 = 4,090.91.
[50] 45,000 – 4,090.91 = 40,909.09.
[51] (140,000 + 60,000) / 220,000 * 45,000 = 40,909.09.
[52] 45,000 – 40,909,09 = 4,090.91.
[53] 45,000 / 220,000 * 100% = 20.5%.
[54] In the event that our taxpayer Johnson would entirely leave a taxing jurisdiction, i.e., if it would move lock, stock and barrel to another country, that taxing jurisdiction should be enabled to adopt a tax measure to ensure the taxation of any subsequent commercial benefits derived from its domestic sources (e.g. the realization of a hidden reserve). This is not further discussed.

transfers of tax sovereignty from the EU MSs to the EU accompanying this), are refrained from being introduced.

This being said nevertheless does not disprove the hypothesis that if the approach as advocated above would actually be implemented in each of the EU MSs' international tax systems unilaterally, the remaining distortions of the internal market would no longer be caused by unilaterally imposed obstacles. The fundamental freedoms would be appreciated. The EU MSs, as seen from their unilateral perspectives, would impose identical tax burdens on proceeds from both domestic and cross-border (i.e., intra-EU) economic activities. The tax sovereignty of the EU MSs in the field of direct taxation would be appreciated. The EU fundamental freedoms would be respected at the same time. I sought to illustrate this by means of a though experiment in which the advocated approach is placed on both sides of the tax border to test the outcome of such an exercise in terms of the unilateral tax burdens imposed.

8 Concluding remarks

What would be the effect if all EU MSs would unilaterally decide to subject all EU resident taxpayers having domestic sources of income to an unlimited income tax liability, while providing for juridical DTR under the Dutch-style 'tax exemption with progression method'? The effect would be that the tax burden imposed by each of these EU MSs would be exactly the same regarding proceeds from both domestic and cross-border (intra-EU) economic activities. Neither the taxpayers' EU place of residence, nor the question of whether the income has been derived from domestic sources or sources across the EU territories would be relevant for that purpose. This would provide a basis for a taxing system without unilaterally imposed distortions of the internal market: a direct taxation system without obstacles.

In this article I illustrate the effects in cases of taxpayers suffering losses from cross-border business activities. In such cases, the 'recapture of foreign losses mechanism' and the 'carry forward of foreign profits mechanism' operate as interconnected tanks, having the effect of entailing tax neutrality and equal tax treatment upon the crossing of EU MS tax borders. Such an 'interconnected tanks effect' would also occur in cases of intra-firm cross-border supplies of services and goods. The advocated approach would also entail equal tax treatment and tax neutrality in cases of intra-firm cross-border transfers of property containing hidden reserves. Accordingly, this could provide a solution to the exit taxation issues that are currently pending before the Court of Justice. The same, notably, holds true in cases where taxpayers realize currency exchange results. I hope to provide for some foundation for these hypotheses in my future tax research.