

The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market

M.F. de Wilde LL.M* and Ms. C. Wisman LL.M**

1 Introduction

As of 1 January 2012, the Dutch corporate income tax ('CIT') system provides for international juridical double tax relief ('DTR') under a mechanism referred to in Dutch tax practice as the 'base exemption for foreign business profits'¹ (author's translation).² The newly introduced DTR mechanism replaces the Dutch-style 'tax exemption with progression method'³ in the area of corporate taxation regarding proceeds derived from foreign-source business activities. The rationale for this legislative shift, according to the Dutch tax legislator, is to arrive at an augmented level of converged tax treatment for corporate taxpayers carrying on business operations abroad either directly (i.e., through a permanent establishment; 'PE') or indirectly (i.e., through a subsidiary).⁴ One of the introduced tax effects is that current losses suffered by resident corporate taxpayers from business activities carried on abroad through a PE are no longer taken into account for CIT calculation purposes. The tax legislator implicitly justifies its amendments by labeling the immediate horizontal cross-border loss set-off possibilities as available under the former DTR mechanism as a "*cash flow advantage*" granted to Dutch resident corporate taxpayers. That characterization reveals an underlying normative consideration. We do away with an 'advantage' to arrive at a taxing system devoid of anomalies at this point. The Dutch tax legislator suggests an improvement. But has he not in fact created a disadvantage? And, by doing that infringes upon the spirit of the internal market within the European Union ('EU') in the process?

2 The mechanics of the 'base exemption for foreign business profits'

The newly introduced 'base exemption for foreign business profits' applies to Dutch resident corporate taxpayers (a corporate body or a 'fiscal unity'⁵) deriving profits from foreign sources.⁶ The mechanism operates as follows. First, the taxpayer's worldwide earnings are included in the CIT base ('worldwide profits'). Second, the amount of worldwide profits is adjusted to the 'Dutch taxable base' (author's translation). The 'Dutch taxable base' of a resident corporate taxpayer equals the taxpayer's worldwide earnings as reduced with an amount equal to the 'positive and negative business income items derived from foreign sources' (author's translation).⁷ These foreign source income items are determined according to Dutch tax standards while making reference to their on balance amounts and calculated on a per country basis.⁸ A reduction with a positive on balance amount of foreign source business income according to Dutch tax standards (i.e., a foreign source business profit) entails a lower taxable amount relative to the taxpayer's worldwide income. A reduction with a negative

* Researcher and lecturer, Erasmus University, Rotterdam (EUR), and tax lawyer, Loyens & Loeff NV, Rotterdam, the Netherlands. This article was written as part of the EUR's law faculty research programme on "Fiscal Autonomy and Its Boundaries". The author can be contacted at dewilde@law.eur.nl.

** Researcher and lecturer, Radboud University Nijmegen (RU) and tax lawyer, PwC, Rotterdam, the Netherlands. The author can be contacted at c.wisman@jur.ru.nl. A Dutch version of this article has been published in the Dutch tax weekly *FED Fiscaal Weekblad*, M.F. de Wilde & C. Wisman, *Over de 'objectvrijstelling' en de klok van de interne markt*, no. 2012/41.

¹ The 'objectvrijstelling voor buitenlandse ondernemingswinsten', Articles 15e-j, 23d, 33b-d Dutch Corporate Income Tax Act ('Dutch CITA').

² As proposed in the Dutch Tax Package 2012 (Dutch Parliamentary Papers, Kamerstukken II, 2011-2012, 33003, no. 2). The amendments have been discussed by various Dutch tax scholars. See H. Pijl, *Enkele kanttekeningen bij de objectvrijstelling in het Belastingplan 2012*, NTFR 2011/2223, T. Bender, *Objectvrijstelling voor buitenlandse winst – waarom eigenlijk?*, NTFR 2011/2482, H. Pijl, *De feestdagen en de objectvrijstelling*, NTFR 2011/2710, H. Pijl, *Non-discriminatie: objectvrijstelling voor buitenlands belastingplichtigen*, WFR2012/60 (Pijl 2012), A.J.A. Stevens, *De invoering van een objectvrijstelling voor vaste inrichtingswinsten*, in: Maatschappelijk ingesteld, Opstellen aangeboden aan dr. D.A. Albregtse ter gelegenheid van zijn afscheid van het FEI van de Erasmus Universiteit Rotterdam, eigen uitgave FEI/EUR, Rotterdam 2011, at 129 et seq., and A.J.A. Stevens, *De objectvrijstelling*, NTFR Beschouwingen 2012/4. See further, M.G.H. van der Kroon, *Verslag van het EFS-seminar 'Vaste inrichting versus deelneming*, WFR 2011/1592, T.P.J. van der Pol & M. Evers, *Verslag YIN-seminar Belastingplan 2011*, WFR 2012/28.

³ The 'belastingvrijstelling'.

⁴ See Dutch Parliamentary Papers, Kamerstukken II, 2011–2012, 33003, no. 3, at 13, and Kamerstukken II, 2009–2010, 31369, no. 10, at 27. The 'base exemption for foreign profits' is one of the outcomes of the Dutch tax legislator's quest for a fairer corporate taxation of multinational enterprises ('MNEs') and small and medium sized enterprises ('SMEs'). Specifically, the legislator seeks a balanced distribution of CIT burden in this respect, Kamerstukken II, 2009-2010, 31369, no. 1.

⁵ A 'fiscal unity' is a group of tax-consolidated affiliated corporate bodies. Upon request, tax consolidation is enabled under the 'fiscal unity regime' for corporations having their place of effective management in the Netherlands provided that the parent company holds at least 95% of the nominal issued and paid-up capital of the subsidiary, Article 15 Dutch CITA. See further footnote 25.

⁶ Article 15e, paragraph 1, Dutch CITA.

⁷ Leaving aside vertical loss compensation, Article 20 Dutch CITA.

⁸ In the event that a double tax convention ('DTC') applies, the resident taxpayer's 'foreign source income items' basically comprise of foreign PE profits, proceeds from immovable property situated abroad and (other) income items with respect to which the Netherlands is required to grant DTR by means of an exemption. If no DTC applies, a comparable definition is in place. Article 15e, paragraph 2, subparagraph a and b Dutch CITA.

on balance amount of foreign source business income (i.e., a foreign source business loss) results in a higher taxable amount relative to the taxpayer's worldwide income.

Contrary to its designated term, the new DTR mechanism does not operate as a true base exemption mechanism which one typically finds in international taxation. Under a true base exemption, foreign source income items are not taken into consideration when determining the taxable amount.⁹ These are ignored for tax base calculating purposes.¹⁰ The Dutch 'base exemption for foreign business profits' however, does not exempt foreign income from the taxable base. It merely operates as an arithmetic tool to adjust the taxpayer's worldwide earnings to the designated Dutch part thereof. In addition, the tax legislator upholds its distinctive recognition, for CIT purposes, of the 'contributory profit' of the foreign PE to the 'overall profit' of the resident taxpayer, on the one hand, and the 'PE's profit' for which juridical DTR is granted on the other.¹¹ Without entering into a detailed technical description of these phenomena, differences between the contributory profit and the PE's profit arise in case of currency exchange results and internal dealings or internal asset transfers.¹² The introduction of a strict territorial system would have put an end to these distinctions. Since the 'base exemption for foreign business profits' operates as a fictitious tax base correction mechanism, it would have been sounder to designate the legislative instrument accordingly to avoid any misunderstanding.

However, the 'base exemption for foreign business profits' does share some characteristics with a true base exemption mechanism. Like a true base exemption mechanism¹³, it takes into account the concept of 'tax territoriality', i.e., the mere recognition of domestic sources of income for tax calculation purposes, to a greater extent.¹⁴ That is, relative to the DTR mechanism it has replaced. Consequently, it appreciates the concept of the 'ability to pay' to a much lesser extent than its predecessor, as the tax is levied on an amount deviating from the actually derived worldwide business income.¹⁵ The new DTR mechanism, for instance, has effectively put to an end the (temporary) import of foreign source losses. A taxpayer may no longer offset foreign source losses against its domestic source profits within the same tax year for Dutch CIT calculation purposes. In this respect the effects are similar to those under a true base exemption mechanism, which does not allow for any cross-border loss set-off either. This may explain the corresponding parlance.

3 *Legislature: "Enhanced equal corporate tax treatment for resident taxpayers' foreign business operations regardless of the legal form chosen"*

By introducing the 'base exemption for foreign business profits' the Dutch tax legislator seeks to achieve an enhanced equal CIT treatment for Dutch resident taxpayers operating their businesses in a foreign tax jurisdiction, regardless of how these foreign business operations have been legally organized.¹⁶ Hence, equal CIT effects irrespective of whether the resident corporate taxpayer conducts its business abroad either directly (i.e., through a PE) or indirectly (i.e., through a controlled subsidiary, which for CIT purposes is referred to as a 'participation'). The Dutch tax legislator seeks to promote the neutrality of legal form in the field of CIT to the extent that it concerns the export of the production factor of enterprise. In our view, this, as part of the general concept of 'tax neutrality', is a fair tax policy consideration. The legal forms in which (foreign) business operations are structured do not affect the actual amount of economic benefits. Therefore, the legal form should not, or to the least extent, affect the volume of tax payable.¹⁷

Until 1 January 2012, the neutrality of legal form had been promoted to a lesser extent than is the case today. This, due to the differences in the juridical DTR and economic DTR mechanisms that applied up to that

⁹ See for instance the exemption mechanism as laid down in Article 23A OECD Model Tax Convention.

¹⁰ Foreign source income items may, nevertheless, be recognized for the mere purpose of determining progressivity in the applicable tax rates against which the domestic income is subsequently taxed. Such a base exemption mechanism is typically referred to as a 'tax exemption with progression'.

¹¹ Respectively, the 'bijdragewinst', the 'generale winst' and the 'vaste inrichtingswinst'. These concepts were already recognized under the former Dutch DTR mechanism.

¹² Numerical examples can be found in C. Wisman, *Artikelsgewijs NDFR-commentaar op de objectvrijstelling voor buitenlandse ondernemingswinsten*, art. 15e e.v. *Wet Vpb*, Sdu fiscale en financiële uitgevers. This online 'Annotated Article-by-Article Database' entitled 'Fiscale Encyclopedie NDFR (Nederlandse Documentatie Fiscaal Recht)' is available to subscribers at: www.ndfr.nl. For details and numerical examples regarding the effects of the Dutch-style 'tax exemption with progression method', see Maarten F. de Wilde, *Currency Exchange Results - What If Member States Subjected Taxpayers to Unlimited Income Taxation Whilst Granting Double Tax Relief under a Netherlands-Style Tax Exemption?*, Bulletin for International Taxation, 2011 (Volume 65), No. 9 and Maarten F. de Wilde, *Intra-Firm Transactions - What if Member States Subjected Taxpayers to Unlimited Income Taxation whilst Granting Double Tax Relief under a Netherlands-Style Tax Exemption?*, Bulletin for International Taxation, 2011 (Volume 65), No. 12. Any differences between the contributory profit and the PE's profit because of currency exchange results and internal dealings or internal asset transfers are not further discussed.

¹³ Or the limited taxation of non-resident taxpayers.

¹⁴ See Dutch Parliamentary Papers, Kamerstukken II, 2009–2010, 31369, no. 9.

¹⁵ Cf. Bender, *supra* note 2.

¹⁶ See Dutch Parliamentary Papers, Kamerstukken II, 2011–2012, 33003, no. 3, at 13 and Kamerstukken II, 2009–2010, 31369, no. 10, at 27.

¹⁷ See Klaus Vogel, *Worldwide v. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part II)*, Intertax 1988/10, at 319.

date. In particular, while losses incurred by a foreign PE were available for immediate offset against domestic profits of the resident corporate taxpayer, current losses derived from business activities carried on through a foreign subsidiary were not taken into account for Dutch CIT calculations.

The Netherlands provided juridical DTR for foreign source active income under the 'tax exemption with progression method'.¹⁸ Contrary to what is sometimes assumed, this DTR mechanism is conceptually not a base exemption method either.¹⁹ The Dutch-style 'tax exemption' operates as a credit mechanism. First, the taxpayer's worldwide earnings are included in the CIT base ('worldwide profits'). This holds true also in the event that a DTC applies. In such cases, the Netherlands reserves the right, when taxing Dutch resident taxpayers, to include foreign-source income (positive and negative) in the tax base.²⁰ Second, DTR is granted with regard to the foreign-source income that is included in the domestic tax base under Dutch tax law.²¹ Subsequently, the Dutch tax payable is determined by crediting the Dutch tax attributable to the foreign-source income against the Dutch tax calculated by reference to the taxpayer's worldwide income.²² One of the tax effects of applying this DTR mechanism is that any current foreign source business losses suffered are taken into account for CIT base calculations (that is, in the same taxable period as in which these losses have actually been incurred, notably, analytically leaving aside any potential differences between profit calculations for CIT purposes on the one hand and commercial accounting purposes on the other). The import of tax losses, however, is intended to be temporary. If the resident taxpayer manages to derive profits from its foreign business ventures in subsequent years, no DTR is granted as long as the losses taken into account earlier have not been recaptured ('mechanism for recapture of foreign losses').²³

To the extent that resident taxpayers carry on their business operations abroad indirectly, the Netherlands provides for economic DTR by means of a base exemption mechanism under the participation exemption regime.²⁴ As a rule, the Dutch CIT system taxes corporate entities on a stand-alone basis, regardless as to whether they are part of an integrated group (the separate entity approach).²⁵ Consequently, taxable earnings include shareholding proceeds (e.g., dividends, capital gains/losses). Under the application of the participation exemption regime however, proceeds from an actively held participation are fully exempt from the CIT base. Eligible to qualify as 'participation' are equity investments of at least 5 per cent in the nominal paid-up capital of the underlying company. The participation exemption applies to both positive proceeds (e.g. dividends, capital gains) and negative proceeds (capital losses, impairments) from a participation.

¹⁸ See M.F. de Wilde & G.T.W. Janssen, *The Netherlands – Key practical issues to eliminate double taxation of business income*, in *Cahiers de droit fiscal international*, Vol. 96b, sec. 2. (Sdu Uitgevers 2011), Online Books IBFD. Today, the Dutch-style 'tax exemption with progression method' generally applies to resident taxpayers, individual natural persons, having active income from foreign sources.

¹⁹ The Dutch DTR mechanism for active income from foreign sources which had been applied in the Netherlands until 1 January 2012 is referred to in the international tax literature as the "exemption-with-progression" method. See B.J. Arnold & M.J. McIntyre, *International Tax Primer*, 2nd ed. at 33-34 (Kluwer Law International 2002). It is also referred to in international tax literature as a "base exemption mechanism", pursuant to which "the foreign source income is initially included in the taxpayer's income for the limited purpose of determining the average tax rate that would apply to that income if the foreign income were taxable". In addition, it is generally stated that the "average rate is then used to compute the actual tax due on the taxpayer's domestic source income". This is, unfortunately, an erroneous description of this Dutch juridical double tax relief mechanism. Furthermore, the ECJ (for example, in *X Holding v. Staatssecretaris van Financiën* (Case C-337/08)) appears not to appreciate fully the operation of the mechanism. Indeed, it does not function in such a way that it exempts foreign source income from the tax base. Conceptually, despite the reference to the phrase "tax exemption", which mirrors the ambiguous Dutch term "*belastingvrijstelling*" which literally means "tax exemption" – presumably thereby giving rise to the confusion – , the double tax relief mechanism operates as a credit.

²⁰ The 'tax base reservation' or, in Dutch, 'grondslagvoorbehoud'.

²¹ The 'tax base requirement' or, in Dutch, 'grondslageis'.

²² DTR is calculated without taking the foreign tax burden into account. Conceptually, a credit is provided for domestic tax attributable to the foreign income. In its application, the methodology operates in a way that is akin to the second limitation commonly applied with regard to international taxation under an ordinary credit mechanism. However, the second limitation applies on a stand-alone basis, i.e. without referring to the foreign taxes levied, as is typically the case under the first limitation under the ordinary credit mechanisms.

²³ For details and numerical examples, see Maarten F. de Wilde, *What if Member States Subjected Non-Resident Taxpayers to Unlimited Income Taxation whilst Granting Double Tax Relief under a Netherlands-Style Tax Exemption?*, Bulletin for International Taxation, 2011 (Volume 65), No. 6. Transitional provisions apply to resident taxpayers who have derived foreign source or domestic source business losses in the taxable periods before January 2012 with respect to which the 'mechanism for recapture of foreign losses' (Articles. 31-33 Unilateral Decree for the Avoidance of Double Taxation 2001, 'UDADT 2001') and the 'mechanism for carry forward of foreign profits' (Articles 34 and 35 UDADT 2001) apply, Article 33b Dutch CITA and Article 35 UDADT 2001 (i.e., the latter as amended per 1 January 2012).

²⁴ Article 13 Dutch CITA.

²⁵ For group companies, an exception to this economically inefficient CIT treatment is made under the so-called 'fiscal unity regime', Article 15 Dutch CITA. Notably, the tax consolidation regime does not apply in cross-border scenarios (see further footnote 42). Another effect of adopting such a territorial approach regarding indirect foreign business operations under the participation exemption regime is that currency exchange results are exempt from the CIT base as well. This holds true as regards to currency exchange results realized on the underlying business operations as well as the equity investment in the foreign subsidiary. On the basis of the consistent case law of the Dutch Supreme Court, a currency exchange result on an equity investment eligible for economic DTR is considered to be a proceed from a participation (Dutch Supreme Court, 9 June 1982, BNB 1982/230). Such results are exempt from the CIT base if the participation is eligible for economic DTR under the participation exemption regime. An exception to this rule can be found in Article 28b Dutch CITA (see further footnote 30). Moreover, intra-group transfers of property, for instance a capital asset transfer between the Dutch parent company and the foreign subsidiary, entail the imposition of CIT on the hidden reserve, which immediately becomes due.

The Dutch CIT system maintains this approach unambiguously to the extent that resident corporate taxpayers carry on business operations abroad via a controlled subsidiary. Accordingly, the proceeds derived from foreign business activities carried on through controlled subsidiaries are kept completely outside Dutch taxation. Hence, a strict territorial approach towards taxing corporate business income. As a consequence, current losses suffered abroad do not affect the taxable base in the Netherlands.²⁶ These losses are also not taken into account indirectly, that is, as a capital or impairment loss on the equity investment. This holds true due to the application of the participation exemption regime.²⁷ There is one exception to the non-allowance of loss import: the 'liquidation losses set-off regime'.²⁸ Under certain conditions, final losses realized at the level of the corporate shareholder upon the liquidation of the (foreign) company in which the participation is held may be deducted, provided that, basically, the underlying business operations are actually discontinued by the group as well.

Hence, until 1 January 2012, the non-neutral CIT treatment entailed that resident corporate taxpayers to a certain extent were free to decide on the manner in which the Dutch CIT system dealt with foreign source business losses. Business operations directly carried on abroad enabled current losses to be taken into account (i.e., horizontal loss set-off), while the carrying on of such operations indirectly did (and does) not. In the latter case, a loss set-off is only allowed upon liquidation (i.e., vertical loss set-off).²⁹ Obviously, such an arbitrary tax treatment distorts decisions on the legal structuring of business activities.

To cut back this arbitrage to the extent that it concerns foreign source business losses suffered by resident corporate taxpayers, the Dutch tax legislator has brought the CIT effects into line regardless of their (legal) organization. Analogous to the treatment of losses of foreign subsidiaries, the import of losses or cross-border loss relief regarding foreign PEs is postponed to a future date. The converged CIT treatment of PEs and foreign participations in this respect is complete³⁰, since so-called 'final foreign PE losses' may be set-off against Dutch-source profits under the so-called 'cessation regime' (author's translation). Final foreign PE

²⁶ Another effect of adopting such a territorial approach regarding indirect foreign business operations under the participation exemption regime is that currency exchange results are exempt from the CIT base as well. This holds true as regards to currency exchange results realized on the underlying business operations as well as the equity investment in the foreign subsidiary. On the basis of the consistent case law of the Dutch Supreme Court, a currency exchange result on an equity investment eligible for economic DTR is considered to be a proceed from a participation (Dutch Supreme Court, 9 June 1982, BNB 1982/230). Such results are exempt from the CIT base if the participation is eligible for economic DTR under the participation exemption regime. An exception to this rule can be found in Article 28b Dutch CITA (see further footnote 30). Moreover, intra-group transfers of property, for instance a capital asset transfer between the Dutch parent company and the foreign subsidiary, entail the imposition of CIT on the hidden reserve, which immediately becomes due.

²⁷ Capital and impairment losses on the equity investment are, as a rule, included in the taxable base. Consequently, such a loss may be deducted. If the equity interest is however considered to be a participation, which is eligible for economic double tax relief under the participation exemption regime, a deduction of such losses is rendered impossible as all proceeds from a participation – both positive and negative, including impairments – are excluded from the taxable base.

²⁸ The 'liquidation loss set-off regime', or in Dutch 'liquidatieverliesregeling', is laid down in Article 13d Dutch CITA. The deductible 'liquidation loss' is generally calculated as the difference between the participation's acquisition price and the sum of the liquidation proceeds.

²⁹ Up until 1 January 2012, the tax legislator sought to tackle undesired implications in this respect with a specific 'claw-back mechanism' laid down in Article 13c Dutch CITA. Today, transitional rules apply in this respect as well (Article 33b Dutch CITA). This is not further discussed.

³⁰ Divergent tax treatment nevertheless remains where it concerns the CIT effects of currency exchange results realized and intra-firm property transfers. Remaining mutual differences under the 'functional separate entity approach' towards PEs and the 'separate entity approach' towards subsidiaries are not further discussed. Currency exchange results are still recognized for CIT and juridical DTR calculation purposes under the 'base exemption for foreign business profits' (as was the case under the 'tax exemption with progression method'). On the contrary, under the current economic DTR mechanism for active income, the participation exemption, currency exchange results remain exempt from the CIT base. Realized hidden reserves upon intra-firm asset transfers from the Dutch head office to the PE abroad remain to be taxed in tranches (as was the case under the 'tax exemption with progression method' as well). On the contrary, under the economic DTR mechanism, economic equivalent intra-group property transfers between a parent and a subsidiary still trigger immediate CIT liabilities on the realized hidden reserves ('exit tax'). Interestingly, the Dutch tax legislator refers to these maintained differences in CIT treatment dependant on the chosen legal form as a necessary consequence of the legal differences between the carrying on of a business through a PE or a participation. See Dutch Parliamentary Papers, Kamerstukken II, 2011–2012, 33003, no. 10, at 26. In our view, this is remarkable, to say the least, as the legal differences were the key argument for the converging CIT treatment regarding foreign source business losses. We have some difficulties understanding the logics behind arguing the policy objective of promoting the neutrality of legal form to adopt converging tax treatment in one area (cross-border loss set-off), while, utilizing the mutual legal differences as an argument to uphold diverging CIT treatment in another (currency exchange results and intra-firm dealings and asset transfers). The legislature has also amended the Dutch CITA with regard to the CIT treatment currency exchange results realized on equity investment that qualify as a participation for economic DTR purposes. Recently, Article 28b Dutch CITA has been introduced. The amendments enable resident taxpayers to opt for conditionally taking into account, for CIT base calculation purposes, currency exchange losses on their participations. Taxpayers may deduct currency exchange losses provided that they successfully litigate their claim through the Dutch court system (including a preliminary ruling by the Court of Justice on the interpretation of the freedoms in this respect). Resident taxpayers awarded with the currency loss deduction are subsequently confronted with the CIT recognition of currency exchange profits on all their participations. At the time of finishing this manuscript, as far as we know, no taxpayer has brought the matter before the tax courts. In Dutch tax literature this tax treatment has been questioned as to its compatibility with primary European Union law. See M.F. de Wilde and C. Wisman, *Tussenregeling valutaresultaten; Gooit Gielen roet in het eten?*, NTFR 2011-1646.

losses are defined as losses realized upon the winding up of the foreign business operations. The 'cessation regime' operates in a manner equivalent to the 'liquidation loss set-off regime' for participations.³¹

The legislator has achieved a more similar CIT treatment for Dutch resident taxpayers with business activities abroad by extending the application of the territoriality principle.

4 *Legislature: "Enhanced equal corporate tax treatment via base exemption by removing timing benefits"*

Conceptually, several alternatives were available to achieve enhanced equal CIT treatment for Dutch resident taxpayers operating their businesses in a foreign tax jurisdiction. The tax legislator, for instance, could have decided to replace the participation exemption regime for an economic DTR mechanism that operates in a way which is akin to the 'tax exemption with progression method', i.e., some kind of 'indirect tax exemption' for grossed-up proceeds from a participation. This has not happened. The 'tax exemption' for juridical DTR purposes has been replaced by the 'base exemption for foreign business profits'. Should we consider the tax legislator's choice for the 'base exemption for foreign business profits' a just one?

A choice out of a variety of available alternatives suggests an underlying motive. During the legislative process, the Dutch tax legislator based its choice for the legislative amendment with the statement that, by doing this, a 'benefit' is removed: "*A base exemption for PE profits takes away the timing benefit of allowing a current cross-border loss set-off under a subsequent recapture mechanism, which, today, is exclusively available to resident taxpayers carrying on their foreign business operations through a PE. That is, relative to the cross-border loss set-off possibilities for resident taxpayers carrying on their foreign business activities through a subsidiary, which is only available upon the liquidation of the subsidiary and the discontinuation of the underlying business activities*" (author's translation).³² These wordings reveals a normative consideration. We do away with a 'benefit' to arrive at a taxation approach which is, at this point, devoid of anomalies. Indeed, the tax legislator suggests an improvement: "*This measure entails a balanced CIT treatment of PEs and participations*" (author's translation).³³ The removal of the 'benefit' has the consequence of arriving at a 'balanced' CIT system.³⁴ To reassure us, the State Secretary for Finance pointed out that such a DTR mechanism "*does not encroach upon the spirit of the internal market*" (author's translation).

5 *Or less equal tax treatment via base exemption by creating (timing) disadvantages?*

5.1 *Legislature creates an imbalance*

One could also refer to the legislator's choice from an opposite point of reference. From that perspective, the CIT treatment regarding the carrying on of foreign business operations through a subsidiary relative to a PE would entail the recognition of a (timing) disadvantage. The legislative amendment then has the effect of exacerbating the disadvantage. In that case, the 'base exemption for foreign business profits' does not put an end to an 'advantage' at all. On the contrary, it creates a disadvantage. By creating that disadvantage, the Dutch tax legislator arrives at an increased imbalanced CIT system which encroaches upon the spirit of the internal market.

What makes a balanced tax system? What are the parameters we should employ? In our view, a balanced tax system is a system that treats economically similar scenarios alike. That is, equal tax treatment in economically equal situations. With the appreciation of the fact that the sovereignty in direct taxation matters retains at the level of the EU Member States ('EU MSs'), this entails, first, that the direct tax system of a state should not distinguish in determining the tax burden on the basis of the taxpayer's nationality or its tax place of residence (the 'equality principle'). Second, it entails that the direct tax system of a state does not distinguish in determining the tax burden as imposed based on the geographical location where the taxpayer employs its production factors of capital, labour and enterprise. Taxation should not affect (or to the least extent possible) the attribution of production factors (the 'neutrality principle'). These normative cornerstones of a fair tax system

³¹ Article 15i Dutch CITA. In our assessments thus far, the tax legislator has made it impossible to undo the deferral of cross-border loss set-off. See Article 15i and 15j Dutch CITA. It is worth noting that the 'cessation regime' applies on a per country basis.

³² See Dutch Parliamentary Papers, Kamerstukken II, 2011–2012, 33003, no. 3, at 13, Tweede Kamer, 2009–2010, 31369, no. 9, at 5, and Tweede Kamer, vergaderjaar 2010–2011, 32 740, no. 1, at 28.

³³ See Dutch Parliamentary Papers, Kamerstukken II, 2011–2012, 33003, no. 3, at 13.

³⁴ The tax legislator forecasts an 'improvement', referred to as the "temporization effect" relative to the former DTR methodology, to produce annual tax revenues worth € 250 million. See Dutch Parliamentary Papers, Kamerstukken I, 2011–2012, no. 33003, no. F, at 1–2, and Kamerstukken II, 2011–2012, 33003, no. 3, at 44. The substantiation of these figures has been kept concise. The Dutch legislator argues that an amount of foreign source losses of presumably € 3 billion are subject to an average loss set-off deferral period of seemingly 11 years. Considering the time value of money, the revenue's yearly cash flow advantage is estimated at € 250 million. Accordingly, the budgetary impact of the introduction of the 'base exemption for foreign business profits' solely is the consequence of the loss set-off deferral.

(amongst others) were already rudimentarily as the ‘maxims of equity’ by Adam Smith in the 18th century.³⁵ Equivalent normative points of departure constitute the cornerstone objectives of the European Union, which, for the purposes of achieving the optimization of the collective well-being of the people within the EU, strives for an equal and non-distortive treatment of those persons moving themselves or their production factors within the European Union territories, an envisaged area without internal frontiers referred to as the internal market.³⁶ The spirit of the internal market stipulates equality and neutrality, also in the field of direct taxation. From this perspective, an imbalanced CIT system is a system that treats economic equivalent circumstances differently. It distorts the attribution of production factors, for instance, within the envisaged internal market without internal frontiers.

The question as to whether the newly introduced ‘base exemption for foreign business profits’ DTR mechanism in the Dutch CIT system should be considered an improvement or a decline can be relatively easily answered if the aforementioned normative basis is taken into the equation. The test becomes a business economics one. If the application of the ‘base exemption’, from an economic perspective, entails a lesser equal and accordingly greater distortive CIT treatment, the DTR mechanism should be considered as a decline. If, from an economic perspective, the application of the ‘base exemption’ entails a more equal and accordingly lesser distortive CIT treatment, the DTR mechanism should be considered an improvement. A more balanced and less arbitrarily functioning taxing system.

From a business economics perspective, the ‘base exemption for foreign business profits’ incontestably produces disadvantages. Essentially, the application of the DTR mechanism limits the offset of actual business losses suffered from (intra-EU) cross-border business activities against the profits of the taxpayer. Consequently, the taxpayer involved faces a higher overall tax cost in the taxable period. Effectively that is, as some of its costs – those having a foreign source – are not taken into account for CIT base calculation purposes. The actual commercial profits and the profits for CIT calculation purposes become out of step to a significantly greater extent. Resident taxpayers suffering real business losses from their business ventures abroad are forced to finance their tax loss set-off entitlements upfront. The business economics disadvantages, at best, constitute a cash flow disadvantage.³⁷ To the extent that resident taxpayers are unable to compensate their current foreign losses with future profits, they lose their conditional tax loss set-off entitlements. In addition, these disadvantages produced by the Dutch CIT system merely affect resident corporate taxpayers who directly or indirectly conduct business operations abroad. Viz., the (cash flow) disadvantages are not forced up to resident taxpayers conducting their business affairs solely within the Netherlands, the domestic environment. Taxpayers who are only commercially active within Dutch territory are not required to finance their tax loss set-off entitlements upfront.³⁸ This creates a bias towards investment in the taxing jurisdiction in which the taxpayer already derives taxable profits, which in this case would be the Netherlands.³⁹ Tax reality differs from the actual business economics reality in economically equivalent scenarios. Accordingly, the introduced ‘base exemption for foreign business profits’ to a greater extent produces an imbalanced CIT system. A decline. By rendering the export of production factors commercially less attractive, the Dutch tax legislator restricts the envisaged functioning of the internal market without internal frontiers. Notably, the comparison of the cross-border investment with the domestic investment has been under-exposed in Dutch parliamentary history. The desired tax convergence merely focuses on resident taxpayers operating their businesses abroad in a direct or indirect manner. Tax convergence with resident taxpayers doing business at home in an indirect or direct manner apparently seems less relevant in the eyes of the Dutch tax legislator.

The limited deduction of intra-EU cross-border losses creates market distortion that the European Commission considered, more than a decade ago, “*from a business perspective, to constitute one of the most*

³⁵ See A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Volume I-III, 8th edition, London, 1796, Volume III, Book V, Chapter II, Part II, at 255-259.

³⁶ See the preamble to the Treaty on European Union (‘TEU’). See also Article 2 TEU in conjunction with Articles 26 and 119 of the Treaty on the Functioning of the European Union. See for a comparison Court of Justice, case 15/81 (*Gaston Schul*) and Frans Vanistendael, *No European Taxation Without European Representation*, 9 EC Tax Review 142 (2000), at 142.

³⁷ Our analysis basically matches the one carried out by the Court of Justice in the case *Rewe Zentralfinanz* (Court of Justice, 29 March 2007, case C-347/04). In *Rewe Zentralfinanz*, the Court of Justice refers to an imposed cash flow disadvantage to rule a German CIT write-off limitation on foreign equity investments incompatible with the freedom of establishment. The timing of the write-off differentiated depending on the tax place of residence of the respective legal entity in which the German corporate body holds its equity investment. To the extent that it concerned an equity investment in a company having its tax place of residence in Germany, the German CIT legislation allowed for an immediate write-off for CIT base calculation purposes in line with business economics reality. If it concerned an equity investment in a company having its tax place of residence within another MS, the German CIT legislation merely allowed for a write-off for CIT base calculation purposes to the extent the equity investment produced positive earnings. As, typically, costs precede profits, equity investments in German companies are treated favorably for tax purposes (*tax write-off today*) in comparison with equity investment in non-German EU companies (*tax write-off perhaps tomorrow*).

³⁸ This holds true to the extent that taxpayers did not on-balance suffer a tax loss. On-balance tax losses are typically carried forward to subsequent tax years (vertical loss set-off). Contrary to, for instance, VAT no tax refunds occur in the area of direct taxation.

³⁹ Cf. Michael P. Devereux, *Debating Proposed Reforms of the Taxation of Corporate Income in the European Union*, 11 International Tax and Public Finance 71 (2004), at 75.

important obstacles to cross-border economic activity".⁴⁰ It is no coincidence that the possibility to horizontally offset cross-border losses continually is referred to as one of the spearhead welfare optimizing features of the European Commission's CCCTB proposal.⁴¹ From this perspective, the enhanced territorial taxation approach as adopted by the Netherlands per 1 January 2012 should be considered as a retrograde step. A disincentive for cross-border trade.

5.2 The imbalance further outlined

Two scenarios

The created imbalance under the Dutch CIT system can be illustrated by means of some stylized numerical examples. For this purpose, we compare the economically equivalent scenarios of "*Domestic X Group*", i.e., our '*Benchmark Case*' and "*Cross-Border Y Group*", i.e., our '*Tested Case*'. We consider both groups to share the following characteristics. Both operate a functionally integrated business enterprise within the internal market during a two-year period. From an economic perspective, accordingly, both X Group and Y Group constitute a single economic entity operating its unitary business enterprise for profit.⁴² X Group is exclusively active within a domestic or non-cross-border economic environment. It operates solely within Netherlands' territories. Y Group conducts its integrated business operations in an intra-EU cross-border economic environment. It operates both in the Netherlands and Belgium. The business profits produced by X Group and Y Group are identical.

Before we proceed calculating, the following remark should be made. It is emphasized that the fact that one case ("*Domestic X Group*") deals with the attribution of production factors in a domestic environment, while

⁴⁰ See Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: *Towards an Internal Market without tax obstacles - A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities*, Brussels, 23.10.2001, COM(2001) 582 final, at 39.

⁴¹ See the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011)121/4.

⁴² This unitary character holds irrespective of whether the business operations are legally concentrated within a single legal entity or legally segregated within a number of legal entities. Indeed, we essentially consider that form is not to be elevated over substance in corporate taxation. Consequently, *analytically*, no CIT difference should result to the extent companies conduct their business operations 'directly', i.e., through branches or 'indirectly', i.e., through the incorporation of controlled subsidiaries. Hence, we appreciate the rationale of the firm as being one economic entity to build our analysis of the Dutch CIT system. This approach may be recognized to echo the established 'theory of the firm' developed by Coase, and the 'unitary method' it essentially promotes in the area of international corporate taxation. This is not further discussed. For some discussion see R.H. Coase, *The Nature of the Firm*, 4 *Economica* 386 (1937) at 386-404. See also Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 *Tax Notes* 625 (1988) at 666-667, Jinyan Li, *Global Profit Split: An Evolutionary Approach to International Income Allocation*, 50 *Can. Tax J.* 823 (2002) at 832-833, Kerrie Sadiq, *The traditional Rationale of the Arm's length Approach to Transfer Pricing – Should the Separate Accounting Model Be Maintained for Modern Multinational Entities?*, 7 *Journal of Australian Taxation* 196 (2004) at 237-238, and Richard D. Pomp, *Issues in the Design of Formulary Apportionment in the Context of NAFTA*, 49 *Tax L. Rev.* 795 (1993), at 806-811. We are very much aware that we diverge from the separate accounting model as typically adopted in the international tax regime. Under separate accounting each legal entity constitutes a separate corporate taxpayer. We analytically depart from that approach as its recognition implicitly and essentially entails the non-appreciation of the desired neutrality of the legal form. As diverging intra-group legal realities are economically insignificant, we have chosen to not build our analysis on the separate entity approach. Viz., it is the separate accounting model which causes the problems we are seeking to identify and resolve in this paper.

Conveniently, the Dutch CIT system has been traditionally acquainted with a tax regime that recognizes the unitary business approach, i.e., the 'fiscal unity regime' (Article 15 Dutch CITA, see also footnote 25). The regime provides for a full tax consolidation of affiliated group companies. Notably, we do not scrutinize the group definition requirements that need to be met. We simply assume that the group definition under Article 15 corresponds with the economic entity, and that the tax consolidation applies mandatory (i.e., to avoid arbitrage possibilities leaking in). Under the application of the tax consolidation regime, substantially all intra-group legal realities are eliminated for Dutch CIT purposes. Accordingly, as we seek to identify and subsequently cancel out the tax induced distortions of the forms of legal organization imposed by the Netherlands CIT system, we consider it useful to benchmark our analysis from the perspective of analytically disregarding the differences in the manner in which corporate families are organized legally. This enables us to put on a parity the business operations undertaken by X Group and Y Group regardless of the legal forms chosen, thereby adopting an approach which promotes the neutrality of the legal form.

Consequently, the presence of this regime in the Dutch corporate tax system neatly bridges the gap between theory, i.e., the unitary approach, to Dutch tax practice, i.e., the 'fiscal unity regime', thereby bypassing separate accounting. This enables us to analytically take together economically equivalent scenarios under different legal organizations, referred to in the paragraphs hereunder as the alternative 'direct' and 'indirect' cases. Finally, please note that we are very much aware of the limited application of the Dutch fiscal unity regime in a cross-border environment. The regime applies merely to the extent the group companies involved operate their unitary business within Netherlands' territories. The regime does not allow for cross-border tax consolidation, thereby reintroducing separate accounting in the cross-border environment, consequently unilaterally restricting outbound direct investment. This restrictive Dutch CIT treatment, nevertheless, has been sanctioned by the Court of Justice in *X Holding*, *supra* note 19. This matter is not further discussed here as our primary focus, today, is on the Dutch 'base exemption regime'. For an analysis of *X Holding* and (non-)cross-border tax grouping, see Maarten F. de Wilde, *On X Holding and the ECJ's ambiguous approach towards the proportionality test*, 19 *EC Tax Review* 170 (2010), at 170-182. For an analytical comparison, worth noting is the approach found in the European Commission's Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011)121/4. The cross-border tax grouping is considered one of the most significant welfare optimizing elements of the CCCTB. As the European Commission forwards: '*Allowing the immediate consolidation of profits and losses for computing the EU-wide taxable bases is a step towards reducing over-taxation in cross-border situations and thereby towards improving the tax neutrality conditions between domestic and cross-border activities to better exploit the potential of the Internal Market*', see Explanatory Memorandum of the proposed CCCTB Directive, p. 5.

the other case (“Cross-Border Y Group”) deals with the attribution of production factors in an intra-EU cross-border environment is of no analytical significance. This holds true from both a business economics perspective as well as from the perspective of the internal market without internal frontiers. Simply put, we address two entrepreneurs, X Group and Y Group who operate their functionally integrated business as single economic entities within an integrated single European market. Consequently from that perspective, also for Dutch CIT purposes, there should be no difference in the treatment of these equivalent cases. The unilaterally imposed effective Dutch CIT burdens should be identical.⁴³ Notably, we limit our analysis to the case of an intra-EU outbound direct investment from the Netherlands to abroad. Hence, we address the Dutch CIT effects regarding the export of the production factor of enterprise by a Dutch entrepreneur, the ‘outbound scenario’ from the ‘home state’ perspective. The effects on production factor imports, the ‘inbound scenario’ from the ‘host state’ perspective, are not addressed.

Scenario 1: ‘X Group’ – Domestic scenario – ‘Benchmark Case’⁴⁴

A Dutch resident taxpayer, X Group B.V., operates two businesses, two branches of activities. One branch is situated in Utrecht, the Netherlands, the other is situated in Rotterdam, the Netherlands.

- In the *first* alternative, ‘Case Direct’, X Group B.V. conducts its functionally integrated business operations directly;
- In the *second* alternative, ‘Case Indirect’, X Group B.V. operates its Utrecht and Rotterdam branches via controlled subsidiaries, *Utrecht B.V.* and *Rotterdam B.V.* Upon the request of the entities involved, *Utrecht B.V.* and *Rotterdam B.V.* have been tax consolidated under the application of the Dutch ‘fiscal unity regime’.⁴⁵ In effect, X Group B.V. is considered the substantive corporate taxpayer conducting the two branches of business activities directly for CIT calculation purposes. Focusing on business economics realities, economically insignificant intra-group legal realities are disregarded for CIT calculation purposes (‘full tax consolidation’). Conceptually, the Dutch tax consolidation regime aligns with the unitary taxation concept as it eliminates, for CIT calculation purposes, economically insignificant intra-group legal realities. The Dutch tax consolidation concept accordingly elevates substance over form.
- The produced business profits are identical in both alternative cases;
- The CIT rate is assumed to equal a linear 25%.⁴⁶

In year 1, the commercial profits produced by the Utrecht branch equals € 100. The Rotterdam branch produced a profit of <€ 80> (i.e., a loss). In year 2, the Utrecht branch’s profit equals € 50. In that year, the Rotterdam branch produces a profit of € 100. Accordingly, the overall business profits realized in year 1 and year 2 equal € 170. The CIT effects are as follows.

Fig. 1. ‘Case Direct’ (nominal amounts)

	Year 1	Year 2	Cumulative Yrs. 1-2
Comm. profit Utrecht	100	50	150
Comm. profit R’dam	<80>	100	20
Comm. profit Group X bv	20	150	170
Taxable profit	20	150	170
CIT payable (25%)	5	37.50	42.50
Attribution CIT Utrecht	25	12.50	37.50
Attribution CIT R’dam	<20>	25	5

Fig. 2 ‘Case Indirect’ (nominal amounts)

	Year 1	Year 2	Cumulative Yrs. 1-2
Comm. profit Utrecht bv	100	50	150
Comm. profit R’dam bv	<80>	100	20

⁴³ Please note that we do not take into account the distortive effects caused by mutual tax differentials, i.e., market distortions that arise as a result of the disparities in the CIT systems of the EU MSs. This constitutes an analytically separate matter.

⁴⁴ Please note, that we build our analysis on this base case. In the purely domestic scenario, no distortions in the organizational form arise. There is a tax parity regardless of the legal forms chosen due to the application of the fiscal unity regime. That is, under the assumption of mandatory tax consolidation and a tax group definition corresponding to economic reality. This matter is not further discussed at this place.

⁴⁵ Article 15 Dutch CITA. See footnotes 5, 25 and 42.

⁴⁶ In addition, we assume that the applied CIT concept of income and the attribution of the CIT base to taxable years operate tax-neutrally. For instance, we ignore additional distortions that occur due to differentiations between the CIT base and the commercial profits. We also ignore the financing discrimination issues that are apparent in the Dutch CIT system. Moreover, we consider the allocation of the taxable base to taxing jurisdictions to operate tax-neutrally as well. We disregard the distortive effects as caused by the application of the at arm’s length principle. Finally, we consider the tax consolidation to completely match the economic entity. For the purpose of our analysis, we maintain the restricted scope of application of the Dutch tax consolidation regime in a cross-border environment in our assumptions (i.e., the non-allowance of a cross-border fiscal unity).

<i>Comm. profit Group X bv</i>	20	150	170
<i>Taxable profit (tax consolidation)</i>	20	150	170
<i>CIT payable (25%)</i>	5	37.50	42.50
<i>Attribution CIT Utrecht</i>	25	12.50	37.50
<i>Attribution CIT R'dam</i>	<20>	25	5

In year 1, the economic entity X Group generates a combined commercial profit of €20. This commercial given is respected when the CIT payable is calculated. Regardless the chosen legal forms, X Group owes the Dutch tax authorities €5 CIT on a taxable profit of €20. In year 2, X Group produces a combined commercial profit of €150. This too is respected when the CIT payable is calculated. Accordingly, regardless of the chosen legal form, X Group owes the Dutch tax authorities €37.50 CIT on a taxable profit of €150 in year 2. Overall, X Group pays €5 + €37.50 = €42.50 CIT on an overall profit of €170. The attribution of CIT to the Utrecht branch respectively equals €25 in year 1 and €12.50 in year 2, i.e., an on balance amount of €37.50 tax. This corresponds with the Utrecht commercial profits of €100 and €50 respectively in years 1 and 2. The functional attribution of CIT to the Rotterdam branch respectively equals <€20> in year 1 and €25 in year 2, i.e., an on balance amount of €5 tax. This corresponds with the Rotterdam commercial profits of <€80> and €100 respectively in years 1 and 2.

Under the aforementioned assumptions, in the domestic scenario the CIT liability is determined in a neutral and balanced manner. The CIT reality and the business economics reality match. Economic equivalent scenarios are tax treated in the same way. The choice of legal form does not alter the tax treatment.

Please note that the neutral CIT treatment regardless of the legal structuring of X Group's business affairs has been caused solely by the application of the tax consolidation regime. The economic entity, the group, is essentially considered to be the taxable unit, thereby favoring business economics reality over the legal structuring. One may recognize some form of unitary taxation in this respect.⁴⁷ Please note that *without the presence of the tax consolidation regime*, Group X in 'Case Indirect' would be forced to wind up Rotterdam B.V. and cease its activities just to be able to horizontally set-off the year 1 Rotterdam loss of <€80> against the year 1 Utrecht profit of €100. Forcing corporate taxpayers to liquidate subsidiaries and to cease trading to solely enable a tax loss set-off in line with economic reality seems undesirable to us. The Dutch tax legislator shows evidence of sharing this opinion given the presence of the tax consolidation regime in the Dutch CIT system today.

Scenario 2: 'Y Group' – Cross-border scenario – 'Tested Case'

A Dutch resident taxpayer, Y Group B.V., operates two businesses, two branches of activities. One branch is situated in Utrecht, the other is situated in Antwerp, Belgium.

- In the *first* alternative, 'Case Direct', Y Group conducts its business operations directly;
- In the *second* alternative, 'Case Indirect', Y Group operates its Utrecht and Antwerp branches via controlled subsidiaries, Utrecht* B.V. and Antwerp BVBA. Upon request, Y Group B.V. and Utrecht* B.V. have been tax consolidated under the application of the Dutch tax consolidation regime. Y Group B.V. is considered to be the substantive corporate taxpayer conducting the Utrecht branch of business activities directly for CIT calculation purposes. Antwerp BVBA has not been tax consolidated. Under current Dutch CIT legislation, the tax consolidation of foreign subsidiaries is not possible. The Dutch tax legislator follows legal reality to the extent that corporate taxpayers conduct their indirect business activities in a cross-border environment;⁴⁸
- The business profits are identical in both alternative cases;
- The CIT rate is assumed to equal a linear 25%;
- We consider both the effects under the 'base exemption for foreign business profits' method and the now abolished 'tax exemption with progression method'.⁴⁹

In year 1, the commercial profits generated by the Utrecht branch equals €100. In that year, the Antwerp branch produces a profit of <€80> (i.e., a loss). In year 2, the Utrecht branch's profit equals €50. In that year,

⁴⁷ See Maarten F. de Wilde, *A Step towards a Fair Corporate Taxation of Groups In the Emerging Global Market*, 39 Intertax 62 (2011), at 62-84.

⁴⁸ As said, foreign subsidiaries are ineligible to be tax consolidated. Legal reality applies unreservedly. Form is elevated over substance. Up until today, the Court of Justice has approved this restrictive CIT treatment of groups of companies operating a multinational business under EU law in *X Holding*, *supra* note 19. This obviously distorts the choice of organizational form to the extent corporate groups operate their businesses in an intra-EU cross-border environment. See for some comments text accompanying footnote 42.

⁴⁹ We assume the 'contributory profit' of the foreign PE to match the 'PE's profit' for which juridical DTR is available. We accordingly assume that both taxing jurisdictions employ the euro currency. Moreover, we consider intra-firm dealings and intra-firm transfers of assets to be absent.

the Antwerp branch produces a profit of € 100. Accordingly, the overall business profits realized in year 1 and year 2 equal € 170. The CIT effects are as follows.

Fig. 3. 'Case Direct' (nominal amounts)

	Year 1	year 2	Cumulative Yrs. 1-2
Comm. profit Utrecht	100	50	150
Comm. profit Antwerp	<80>	100	20
Comm. profit Group Y	20	150	170
Worldwide taxable profit Group Y bv for Dutch CIT purposes	20	150	170
CIT payable (25%) – Application DTR under 'tax exemption with progression' method (abolished)	5 ⁵⁰	32.50 ⁵¹	37.50
CIT payable (25%) – Application DTR under 'base exemption' method (currently in place)	25 ⁵²	12.50 ⁵³	37.50
Attribution CIT Utrecht	25	12.50	37.50
Attribution CIT Antwerp (DTR)	<20>	25	5

Fig. 4. 'Case Indirect' (nominal amounts)

	Year 1	Year 2	Cumulative Yrs. 1-2
Comm. profit Utrecht bv	100	50	150
Comm. profit Antwerp bvba	<80>	100	20
Comm. profit Group Y	20	150	170
Worldwide taxable profit Group Y bv for Dutch CIT purposes (tax cons.)	100	50	150
CIT payable (25%)	25	12.50	37.50
Attribution CIT Utrecht bv	25	12.50	37.50
Attribution CIT Antwerp bvba	<20>	25	5

In year 1, the economic entity Y Group generates a combined commercial profit of € 20. The Utrecht branch generates a profit of € 100. The Antwerp branch produces a profit of <€ 80> (i.e., a loss). Under the currently applicable CIT system, this commercial given is not respected when the CIT payable is calculated. Regardless of the chosen legal forms, Y Group owes the Dutch tax authorities € 25 CIT payable on a taxable profit of € 100. Consequently, in year 1, Y Group is actually required to pay more tax than the commercial profits it has produced. If we compare the case of Y Group with that of X Group, regardless of the chosen legal form, Y Group is required to pay a *quintupled* nominal amount of CIT payable. The Dutch CIT system has the effect that resident taxpayers operating their business in a cross-border environment, contrary to their counterparts that decided to remain at home, are faced with a shift of their tax loss set-off entitlements to an uncertain future. Y Group is forced to finance, upfront, its (conditional) tax loss compensation claim nominally worth € 20 regarding its Flemish loss of € 80 in year 1. Regardless of the legal structure of the cross-border business affairs, the actual losses suffered *today* can merely be deducted or otherwise set-off against profits produced *tomorrow*. Contrary to the solid horizontal loss set-off claim granted to X Group in year 1, Y Group has to settle for a mere conditional vertical loss compensation claim as Y Group first needs to generate positive income items in future tax years before the Dutch CITA enables Y group to make use of the loss set-off. The prospect of a future profit is uncertain. This holds true especially under the current tendencies of the (inter)national markets. Should Y Group be unable to generate positive income in future years, the conditional receivable on the Dutch tax authorities goes south. An on balance loss at the end of the day does not entail a

⁵⁰ The taxable base equals $100 - 80 = 20$. 5 CIT is accordingly due ($0.25 * 20$). The Flemish loss of 80 needs to be recaptured to the extent the taxpayers manage to derive a profit in a subsequent tax year.

⁵¹ The taxable base equals 150. The CIT calculated on this amount equals 37.50 ($0.25 * 150$). Under the application of the 'mechanism for recapture of foreign losses', the DTR granted equals 5. $(100 - 80) / 150 * 37.50 = 5$. The CIT payable equals 32.50 ($37.50 - 5 = 32.50$).

⁵² The taxable base equals $(100 - 80) + 80 = 100$. The CIT due equals 25 ($0.25 * 100$).

⁵³ The taxable base equals $(50 + 100) - 100 = 50$. The CIT due equals 12.50 ($0.25 * 50$).

tax refund. This holds true regardless of the application of the ‘liquidation loss set-off regime’ or the ‘cessation regime’. Notably, the sole alternative available to Y Group is to close down the Antwerp branch in the first year. That would enable Y group to apply the ‘liquidation loss set-off regime’ or the ‘cessation regime’ in year 1 and to horizontally deduct the Antwerp loss of €80 against the €100 Utrecht profit. In our view, this is equally undesirable as the equivalent scenario regarding X Group in the ‘Indirect Case’ in the absence of the tax consolidation. These domestic CIT effects render the export of production factors undeniably less attractive. It restricts corporate groups in their decision to set up a branch of business activities in a cross-border intra-EU context. Accordingly, the Dutch tax treatment does not promote export neutrality within the internal market.⁵⁴

In year 2, Y Group generates a combined commercial profit of €150. The Utrecht branch generates a profit of €50. The Antwerp branch generates a profit of €100. Regardless of the chosen legal forms, Y Group owes the Dutch tax authorities €12.50 CIT on a taxable profit of €50. Overall, Y Group pays €25 + €12.50 = €37.50 Dutch CIT on an overall Utrecht profit of €150. The Netherlands steps down and provides DTR, which in terms of nominal amounts of tax is worth €20 – €25 = <€5>. This is due to the <€80> + €100 = €20 profit that can be attributed⁵⁵ to the Antwerp branch. The nominal amount of €20 CIT that Y Group has financed upfront *yesterday*, i.e., in year 1, is received back *today*, i.e., in year 2.⁵⁶ Y Group has been lucky. It managed to produce a profit in year 2. Y Group can offset its receivable on the Dutch tax authorities. Had Y Group not managed to derive a profit from its Antwerp branch, Y Group would be unable to ‘cash its cheque with the Dutch tax authorities’. In addition, it should be mentioned that the Dutch tax authorities indeed enable Y Group to set-off the year 1 loss against the year 2 profits. However, no interest is remunerated during this period. Upon shifting the loss set-off entitlement to the future, the Dutch tax legislator did not make the conditional receivable interest-bearing. In comparison with X Group, accordingly, Y Group remains worse off as it is still confronted with a cash flow disadvantage. That is regardless of the substantive vertical loss set-off. In our example, the Dutch tax authorities take away €20 during a 1-year period without compensating Y Group for this. Please keep in mind that the Dutch tax authorities do not confront X Group with this restrictive CIT treatment as the Dutch CITA enables X Group to horizontally set-off the Rotterdam loss against the Utrecht profit in year 1. And note that the cash flow disadvantage imposed on Y Group is the best case scenario.⁵⁷ Viz., the longer it takes for Y Group to produce a profit abroad, the less value its conditional vertical loss compensation entitlement will have (due to the time value of money). Hence, even if Y Group manages to vertically offset the year 1 Antwerp loss against a year 2 profit, the Dutch CIT treatment restricts corporate taxpayers in their decision to set up a branch of business activities in a cross-border intra-EU context. Due to the raised (timing) disadvantages the Dutch CIT system does not promote export neutrality or economic

⁵⁴ Cf. Bender, *supra* note 2.

⁵⁵ That is, according to accepted profit-allocation methodology.

⁵⁶ Please note that we do not enter into our analysis potentially available vertical loss set-off possibilities in Belgium (e.g., loss-carry back). Indeed, no distortion would arise for the taxpayer if Belgium would unilaterally ‘fix’ the problem in the distortive Dutch CIT system on its behalf by providing a loss-carry back. This would be the case, yet only, *to the extent that the Belgian carry back is granted at an amount identical to the Dutch effective average tax rate*. Otherwise the disadvantage imposed by the Netherlands regime, at least to some extent, would remain to exist (which, in our view illustrates the perhaps somewhat hypothetical nature of such a coincidental unilateral fixing operation at the opposite side of the tax border). Yet, theoretically perhaps more important, we take the position that the properties of the scrutinized EU tax system should be tested on their individual merits, i.e., without looking at the tax effects across the tax border. This is for the following reasons. Indeed, it may be argued that the distorting Dutch CIT treatment could perhaps pass muster under primary EU law if one would consider the CIT effects abroad as well, i.e., in our case Belgium. It is true that EU jurisprudence provides examples of cases in which the Court of Justice made the (in)compatibility of an EU MS tax measure with the fundamental freedoms dependent on the tax effects in another EU MS (see e.g. *De Groot*, case C-385/00 – on the tax treatment of personal allowances – and *Marks & Spencer II*, case C-446/03 – on the tax treatment of cross-border losses). This said, yet, worth noting is that there are also examples available in which the court does not. Regarding cross-border losses, reference can be made in this respect to both ‘home state cases’, e.g., (implicitly) *X Holding*, *supra* note 19, and (also implicitly) *C-414/06 (Lidl)*, as well as, since recently, a ‘host state case’, i.e., (explicitly) *C-18/11 (Philips Electronics)*. Regardless of the doctrinal confusion that may be triggered as a consequence of this, the matter has lead some scholars to observe that the Court of Justice applies an ‘always somewhere approach’, on the basis of which, e.g., the unilateral denial by an EU MS of a horizontal cross-border loss set-off otherwise available in a pure domestic scenario is eligible to be justified if some other country allows vertical loss set-off. Others, e.g., Advocate General Kokott in her opinions in *Philips Electronics*, and particularly *C-123/11 (A Oy)*, conversely, argue that one should not look at whatever happens abroad. In our view, regardless of what the Court of Justice observes in this respect, it is – in the style of Walter Hellerstein – undesirable to construct a rule that, for its operation, depends on the present configuration of the tax laws of the other EU MSs. Such an approach would make the compatibility of EU MS tax laws dependent on the shifting complexities of the tax systems of 27 sovereign EU MSs. The (in)compatibility with EU law of the taxes imposed on an individual taxpayer would depend on the particular other EU MS in which it operates. Furthermore, it would encroach upon EU MSs sovereign entitlements to tax income: which hierarchically equal sovereign EU MS should step back in a particular case, the one last to adopt a particular tax rule? Indeed, ‘there is something unseemly about determining tax liabilities “on a first-come-first-tax basis”’. Given the fundamental concerns underlying the fundamental freedoms, it would be perverse indeed to establish a rule rewarding beggar-thy-neighbour EU MS tax policies with EU MS tax collections depending on who won the race to the taxpayer’s door.’ See for this exact same argument – in a conceptually similar but legally different context, i.e., on the constitutionality of U.S. state taxes – Walter Hellerstein, *Is “Internal Consistency” Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation*, 87 Mich. L. Rev. 139. 1988-1989 at p. 170. See further, Walter Hellerstein, *Is “Internal Consistency Dead?: Reflections on an Evolving Commerce Clause Restraint on State Taxation”*, 61 Tax L. Rev. 1, 2007-2008.

⁵⁷ *Ibid.* and accompanying text.

efficiency. It merely enhances the artificial fragmentation of the internal market alongside the national (tax) borders of the EU MSs.⁵⁸

If we compare the CIT consequences under the current and former juridical DTR mechanism, a 'temporization difference' can be determined. Under the application of the, now abolished, 'tax exemption with progression method', Y Group would be liable to pay an amount of €5 Dutch CIT on the actual derived commercial profit of €20 in year 1. That would equal the amount of CIT which X Group is required to pay in that year. Accordingly, the business economics reality would be respected for CIT calculation purposes. In year 2, Y Group would be liable to pay an amount of €32.50 Dutch CIT. Overall, Y Group would pay €5 + €32.50 = €37.50 Dutch CIT on an overall Utrecht profit of €100 + €50 = €150. As is the case with the currently applied DTR mechanism, overall, the Netherlands would step down and provide DTR, which in nominal amounts of tax is worth <€25> + €20 = <€5>. This is due to the <€80> + €100 = €20 profit that can be attributed to the Antwerp branch. The key difference with the current DTR mechanism, the 'base exemption', is that the €20 tax which Y Group would have offset yesterday under the 'tax exemption with progression', in year 1, regarding the Antwerp business loss of €80, would be recaptured today, that is in year 2,. The taxpayer's receivable on the Dutch tax authorities would be offset when the tax loss is suffered. Y Group would set-off the Antwerp loss of €80 against the Dutch profits of €100 at the time the Flemish loss has actually been suffered. Just as is the case with the Rotterdam loss as suffered by X Group. The tax authorities would collect the tax when the profits have been made, i.e., in year 2 under the recapture mechanism. Accordingly, the CIT treatment of the economically equivalent domestic (X Group) and cross-border scenarios (Y Group) would be treated exactly the same for tax purposes. Both X Group and Y Group would be able to horizontally set-off their losses and profits in year 1. Contrary to the currently in place 'base exemption', the application of the 'tax exemption with progression method' would not require Y Group to finance its conditional loss compensation entitlements upfront. Consequently, the now abolished 'tax exemption with progression' operates neutrally.⁵⁹ It leaves corporate groups unrestricted in their decision to take their business across intra-EU national tax borders or not. It promotes tax neutrality within the internal market.

⁵⁸ Cf. Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, *Tax Treatment of Losses in Cross-Border Situations*, Brussels, 19.12.2006, COM(2006) 824 final. See also the technical annexes to this document, Commission staff working document, Annex to the Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, *Tax Treatment of Losses in Cross-Border Situations, Technical Annexes*, Brussels, 19.12.2006, SEC(2006) 1690. The Commission analyses the matters analytically in an identical manner. Notably, one refers to coordination in this respect to resolve the matter. In our view, the reference to required coordination efforts does not mean that the issue concerned should be considered a market distortion caused by disparate tax systems. The market distortions concerned are imposed by a single EU MS. Accordingly, the distortive effects analytically cannot be caused by mutual divergences in the international tax systems within the EU. The reason one needs to resort to a coordinated approach, may be explained by referring to *Marks & Spencer II*, *supra* note 56 in which the Court of Justice approved these kinds of unilaterally imposed cash flow disadvantages. Conceptually, the market distortion at hand should be labeled an 'obstacle' rather than a disparity. In *Marks & Spencer II*, *supra* note 56, the Court of Justice nevertheless allowed EU MSs to uphold such an obstacle. To illustrate this position, we point at the CIT treatment in the Netherlands up to 1 January 2012. Up to that date, the Netherlands unilaterally allowed the cross-border loss-offset. Today, this is no longer the case. Accordingly, the cash flow disadvantage is the sole effect of replacing the Dutch-style 'tax exemption with progression method' with the 'base exemption for foreign business profits' mechanism for juridical DTR purposes. The distortive effects have solely been caused by a change within the Dutch CIT treatment of foreign income. A unilateral legislative turn of events accordingly. Thus, the effects necessarily cannot be the consequence of the combined application of disparate tax systems within the EU only to be resolved by a coordination or harmonization measure. The distortion rests in a unilaterally imposed restriction which the Court of Justice approves for (in our view) indistinct reasons.

⁵⁹ Please note that, contrary to what the Court of Justice has considered, for instance, in *X Holding*, *supra* note 19, the tax exemption mechanism does not effectively allow for taking cross-border tax losses effectively into account in two jurisdictions ('double dip'), i.e., as a horizontal loss in the running tax year in one country and as a vertical loss in a previous or future tax year in another. First, the 'recapture mechanism' would ensure that no DTR is granted in following tax years as long as the losses from earlier years have not been recaptured. Second, if a taxpayer would be so unfortunate not to manage to derive a profit in a future year, indeed the loss may be seen in two jurisdictions. But should that be considered problematical? We consider this not to be the case. The taxpayer at hand has derived a loss in a certain tax year which he has not been able to recoup at a later time. This implies that it had to cease trading. No money has been made to set-off the loss against. So why recapture it and pay tax upon the cessation of the business? We do not see why a loss set-off taken at some earlier times should be recaptured upon the cessation of business when profits in fact have never been realized. Third, indeed, it is true that the Dutch CIT system contained an arbitrage opportunity until 2012. It allowed taxpayers to effectively establish a deferral of the recapture (indefinitely in theory). This had to do with the differences in the CIT treatment of PEs and subsidiaries. As said, the tax exemption regime for PEs allowed current losses to be deducted, while the participation exemption regime for subsidiaries does not. This encouraged taxpayers to initially set up foreign operations through a PE and subsequently to issue them into a participation as soon as the business breaks even. This would render the recapture of PE losses under the tax exemption regime impossible. Initial losses would be deducted while subsequent repatriated business profits would be exempt from the CIT base. Government responded by adopting a claw-back mechanism to counter this effect (Article 13c Dutch CITA, abolished as of 2012, transitional rules apply). Under Article 13c, the participation exemption is unavailable as long as the initially deducted PE losses have not been recaptured. Instant recapturing is required if the taxpayer in effect transfers its participation or underlying business to an affiliate. The recapture mechanism, however, is poorly designed. The recapture is only triggered upon a dividend distribution by the subsidiary. Accordingly, as long as the respective subsidiary stalls dividend payments, the recapture is effectively cancelled out. The matter could have been resolved, for instance, by adopting a fair market value ('FMV') tax accounting requirement in respect of the equity investment to the extent that the deducted losses have not yet been recaptured. It should be noted, though, that the faulty design of Article 13c has little to do with the tax exemption mechanism itself. It should be appreciated that the design issues in the now abolished Article 13c Dutch CITA should analytically be kept separated from observations on the operation of the tax exemption mechanism. The tax exemption should be analyzed on its own merits.

All in all, the corporate taxation of proceeds from cross-border business activities does not occur in a tax-neutral manner under the current DTR mechanism. Equivalent economic circumstances are treated dissimilarly for tax purposes. The CIT reality and the business economics reality do not match. Resident taxpayers doing business abroad are required to finance conditional loss compensation entitlements upfront. The CIT effects are the same, yet to the extent one considers the legal structuring of the resident taxpayers' business affairs abroad. To that extent, the newly introduced DTR mechanism promotes the neutrality of legal form. However, if one compares the tax treatment of Dutch resident taxpayers conducting their businesses abroad to the tax treatment of Dutch resident taxpayers trading at home, the tax neutrality is absent. The DTR system discourages outbound investments. It restricts the export of production factors. The absence of export neutrality has been caused by the transition to a stricter territorial approach under the 'base exemption for foreign business profits'. Territorial tax systems merely promote import neutrality.⁶⁰ They do not promote export neutrality.

The 'temporization difference' that occurs if one compares the tax effects under the 'base exemption for foreign business profits' method to the Dutch-style 'tax exemption with progression method' strikingly illustrates the decline. Under the application of the 'tax exemption' single taxation is recognized in an economically efficient manner, while, simultaneously, the territoriality principle is appreciated as well. An approach which allows for a deduction of cross-border losses when they are economically suffered in combination with a recapture mechanism that applies when the entrepreneur produces a foreign source profit acknowledges the taxpayer's ability to pay. The export of production factors is left unrestricted. The Dutch-style 'tax exemption with progression method' therefore, from a unilateral perspective, promotes export neutrality. In addition, as the DTR mechanism provides for relief for foreign profits calculated according to Dutch standards, the actual tax burden imposed in the source state is left undisturbed. Viz., the DTR mechanism provides for a credit of domestic tax attributable to the foreign income. Accordingly, it promotes import neutrality as well. The newly introduced 'base exemption' also achieves single taxation under the appreciation of the territoriality principle. It also leaves local tax burdens unimpeded. The import of production factors is left unrestricted. The 'base exemption' accordingly promotes import neutrality. However, the 'base exemption' does not consider the taxpayer's ability to pay as the aforementioned example clearly illustrates (€25 CIT payable on €20 worldwide earnings in year 1). The application of the 'base exemption' unilaterally distorts the export of production factors and is, therefore, economically inefficient.

6 The imbalance nevertheless seems legally unassailable

Is the introduced imbalance legally assailable? In the assessments we have made so far, we believe that this is not the case. It has to be said, if one assesses the Dutch legislator's craftsmanship in terms of the legislative techniques employed, the produced CIT legislation is an illustration of high-class tax law drafting.⁶¹ The legislature makes full use of the room made available under the double tax treaty law and European Union law as they stand today.⁶²

Under the current case law of the Court of Justice on the interpretation of the fundamental freedoms in the field of direct taxation, the 'base exemption for foreign business profits' essentially seems to be legally unassailable.⁶³ The Court of Justice allows EU MSs to adopt tax systems deferring the cross-border set-off of business losses. The Court of Justice considers the absence of cross-border loss relief justified unless it concerns final intra-EU cross-border losses. In the *Marks & Spencer II* case, the Court of Justice ruled that

⁶⁰ Notably, the promotion of capital import neutrality is one of the key Dutch tax policy objectives. The objective of promoting import neutrality lies at the heart of the Dutch 'participation exemption' and the 'base exemption for foreign business profits'. See Janssen et al, *supra* note 19.

⁶¹ Cf. Bender, *supra* note 2.

⁶² Worth noting is that restrictions that were already in place prior to the introduction of the 'base exemption' have not been taken away. This holds true, for instance, regarding triangular cases where non-resident taxpayers carry on a business in the Netherlands through a PE to which (passive) income items can be attributed which arise in a third state. The Netherlands does not consistently grant those non-resident taxpayers DTR with respect to these third-country income items. This is not further discussed. See on this matter, Pijl 2012, *supra* note 2.

⁶³ This also holds true with respect to the Dutch CIT treatment of currency exchange results derived from foreign business activities. The adoption of the 'base exemption for foreign business profits' did not alter things in this respect. By enabling these currency exchange results to be taken into account, the Netherlands respects the Court of Justice's ruling in the case *Deutsche Shell* in which the court held the German non-deduction of currency exchange losses that derived from foreign intra-EU business abroad to infringe upon the fundamental freedoms. See Court of Justice, case C-293/06 (*Deutsche Shell*). In addition, the Dutch tax legislator may also be considered to respect the Court of Justice's case law regarding exit taxes. See Court of Justice, cases C-371/10 (*National Grid*), C-9/02 (*Lasteyrie*) and C-470/04 (*N.*). Hidden reserves realized upon the transfer of property from the Dutch head office to the PE abroad are taxed in tranches. The CIT does not become immediately due. Property transfers from the foreign PE to the Dutch head office entail a tax rebasing of the transferred property to its fair value leaving the hidden reserve to be taxed by the source jurisdiction.

such a final foreign source loss should be able to be deducted against domestic profits.⁶⁴⁻⁶⁵ Yet, the court considered the resulting (timing) disadvantage in such an instance not to constitute an infringement of the fundamental freedoms. A conditional loss set-off entitlement for a foreign source business loss suffered today apparently suffices in *Marks & Spencer II*. It should be said, though, that there is some legal uncertainty on this point. In the joined cases *Metallgesellschaft-Hoechst*, the Court of Justice arrived at an opposite conclusion as regards the EU law (in)compatibility of unilaterally imposed cash flow disadvantages. In these cases, the court considered a timing disadvantage imposed by the United Kingdom to be incompatible with the fundamental freedoms.⁶⁶ In addition, the Court of Justice took a similar position in the case *Rewe Zentralfinanz*, which dealt with a cash flow disadvantage imposed by Germany with respect to the corporate taxation of proceeds from cross-border indirect investments relative to the taxation of proceeds from domestic indirect investments.⁶⁷ Regrettably, in some cases unilaterally imposed (timing) disadvantages by EU MSs have been ruled compatible with the fundamental freedoms, while unilaterally imposed (timing) disadvantages have been ruled incompatible in others. *Marks & Spencer II*, on the one hand, and *Metallgesellschaft-Hoechst* and *Rewe Zentralfinanz*, on the other, mutually do not align analytically. We have some difficulties in appreciating these apparent inconsistencies in the Court of Justice's interpretation of the fundamental freedoms.⁶⁸

The 'base exemption for foreign business profits' essentially seems legally unassailable under current Dutch international tax law as well. Under Dutch constitutional law, double tax conventions (DTCs) have priority over domestic tax laws. Domestic tax legislation incompatible with the DTCs in the Dutch DTC network constitute a 'treaty override' and are considered void as a consequence thereof. In our assessment the question as to whether the 'base exemption for foreign business profits' constitutes a treaty override should be answered in the negative. The 'tax base reservation' consistently included in the DTR provision in the DTCs allows the Netherlands to include foreign source income in the CIT base. It does not require the Netherlands to do so. The DTC texts consistently require the Netherlands to merely provide for DTR regarding income items that are included in the CIT base (the 'tax base reservation'). Subsequent to the application of the 'base exemption for foreign business profits', it may be argued that the respective foreign business profits are effectively excluded from the CIT base. That would entail that the Netherlands is not required to also allow for a reduction of the CIT payable under the application of the Dutch-style 'tax exemption'. Arguments for this position can be found in consistent case law of the Dutch Supreme Court. It appears that, as an effect of the tax reduction under the 'tax exemption with progression method', substantially the foreign income items for which DTR has been granted are considered no longer included in the taxable base.⁶⁹ Regardless, this is systematically not the case since the DTR occurs subsequent to the determination of the 'taxable subject', 'taxable base', 'tax rate' and 'tax' (i.e., the analytical build-up of the Dutch CIT system). Consequently, if the foreign income is ruled not to be included in the taxable base subsequent to the application of the tax reduction under the tax exemption, *a fortiori*, this should also be considered the case if the CIT 'taxable base' is being altered under the application of a fictitious correction mechanism, the 'base exemption for foreign business profits'.

7 Concluding remarks

Could the Dutch tax legislator have adopted a fairer approach towards imposing CIT in a cross-border environment? In our view, it could have. The conceptually soundest approach would be to adopt cross-border tax consolidation while providing DTR under the Dutch-style tax exemption method.⁷⁰ Today, politically, this is perhaps a step too far. The alternative would be to replace the participation exemption for economic DTR

⁶⁴ See *Marks & Spencer II*, *supra* note 56. One may argue whether the DTR mechanism infringes upon EU law to the extent that the loss recognized under the 'cessation regime' does not match the 'final loss' under the 'M&S exception'. A conclusion on this matter seems dependant on a further interpretation of the European Court of Justice's case law, in the end by the court itself.

⁶⁵ However, it should be mentioned that the Court of Justice did not refer to its 'M&S exception' in its rulings in the cases *X Holding*, *supra* note 19 and *Lidl*, *supra* note 56). This, notably, has lead Advocate General Kokott to observe in her opinions in *Philips Electronics*, *supra* note 56, and particularly *A Oy*, *supra* note 56, that little room, if any, remains for the M&S exception to be acknowledged under current primary EU law. She opines that the non-recognition of cross-border loss set-off may be fully justifiable solely on territoriality arguments ('balanced allocation of taxing powers'). Accordingly, Kokott seems to encourage the Court of Justice to allow EU MSs to adopt full-fledged territorial taxing systems. It is noted that such tax systems, indeed, promote production factor import neutrality. However, simultaneously, they severely hamper outbound investment. We fail to appreciate why the internal market should necessarily favor import neutrality over export neutrality. In the internal market, intra-EU investment is directed both inward bound and outward bound. Why should EU MSs be permitted under primary EU law to disregard jurisdiction neutrality when taxing the returns from the latter?

⁶⁶ See Court of Justice, cases C-397/98 and C-410/98 (*Metallgesellschaft / Hoechst*).

⁶⁷ See *Rewe Zentralfinanz*, *supra* note 37.

⁶⁸ See footnote 64-65, and accompanying texts.

⁶⁹ See for a comparison Dutch Supreme Court, 8 February 2002, BNB 2002/184 (*Japanese royalty*) and Dutch Supreme Court 11 May 2007, BNB 2007/230 (*Diehoeksinterest 2*).

⁷⁰ See for a comparison De Wilde, *supra* note 47.

purposes with a variant of the ‘tax exemption’, an ‘indirect tax exemption’.⁷¹ Accordingly, economic DTR would be provided by means of an indirect credit for the underlying tax according to Dutch standards regarding the grossed-up proceeds from a participation.⁷² Such a DTR mechanism would enable current cross-border loss set-off by means of a write-off in the equity investment. Single taxation would be achieved by adopting a recapture mechanism.⁷³ Such an approach would render the ‘liquidation loss-set-off regime’ obsolete. That regime could therefore be abolished. An additional effect would be that the economic DTR would be provided on a net basis. Such a transition could perhaps also be considered politically as a step too far. Nevertheless, an interesting side-effect of introducing such a net economic DTR mechanism would be that the Dutch CIT system would no longer provide for interest deductions on debt issued to finance income from equity investments that is not effectively taxed due to the application of the participation exemption. Today, this mismatch between deductible expenses and exempt profits⁷⁴ is considered a major policy issue in the Netherlands.⁷⁵ As of 1 January 2013, the deduction of excess interest on debts deemed to be related to the financing of participations is limited.⁷⁶ Notably, the European Commission too considers double non-taxation due to the deduction of interest expenses on debt financed investments producing tax exempt earnings to be problematical. Recently, it released a document for public consultation purposes in which this matter, amongst others, is touched upon.⁷⁷

We have arrived at our conclusions. The Dutch tax legislator has introduced a restrictive juridical DTR mechanism. The ‘base exemption for foreign business profits’ impedes the proper functioning of the internal market without internal frontiers. It makes outbound investments less attractive for Dutch resident corporate taxpayers as the cross-border loss set-off entitlements available under the Dutch-style ‘tax exemption mechanism’ have been shifted to an uncertain future. Today, resident taxpayers investing abroad are required to finance conditional future loss set-off claims upfront. Resident taxpayers investing at home are not confronted with this restrictive CIT treatment. Accordingly, the Dutch tax legislator impedes the spirit of the internal market by solely making the conduct of intra-EU cross-border business more burdensome. However, the legislature makes full use of the room as made available under the DTC law and European Union law as they stand today. This, nevertheless, does not render untrue our statement that the Dutch tax legislator, in this age of internationalization and globalization, entrenches itself behind domestic tax borders. We believe this to be a countermovement which has little to do with an equal and neutral CIT treatment of economically equivalent scenarios. The Dutch-style tax exemption mechanism – despite it being one in just a handful of neutral elements in the Dutch international tax system – regrettably has left the Dutch CIT arena.

⁷¹ Such an alternate approach requires some additional measures to guarantee tax neutrality. Regarding participations in subsidiaries one would need to adopt additional mechanisms to neutrally deal with currency exchange results and intra-group property transfers. In addition, the incentive to frustrate the recapture should be cancelled out as well. With this we aim at the possibility to defer the recapture by delaying the realization of the proceeds from the participation for CIT purposes (e.g. the deferral of dividend distributions). A recapture in line with business economics reality may be achieved by introducing a fair market value (‘FMV’) tax accounting requirement in respect of controlling equity investments in subsidiaries to the extent that the deducted losses have not yet been recaptured. There is some experience in the Netherlands with FMV tax accounting in respect of substantial equity investments in so-called ‘non-qualifying portfolio participations’ (Article 13a Dutch CITA). See for the CIT treatment of such participations, Janssen et al., *supra* note 18.

⁷² Such a mechanism would operate in a manner akin to the ‘participation credit’ regime, which is currently applied in respect of so-called ‘non-qualifying portfolio participations’. Contrary to a credit calculated by reference to a fictitious underlying tax of 5%, the ‘indirect tax exemption’ would provide for a credit at the regular marginal CIT rate of 25%. For an outline of the ‘participation credit’ regime as it applies today, see Janssen et al., *supra* note 18.

⁷³ In addition, a carry-forward mechanism should be made available to ensure single taxation in the event that taxpayers derive domestic source losses while earning a profit from their indirect business operations abroad. See for some details and numerical examples of the carry-forward mechanism under the Dutch-style tax exemption mechanism, De Wilde, *supra* note 23.

⁷⁴ This mismatch is typically referred to as the ‘Bosal mismatch’, named after the Court of Justice’s ruling in case C-168/01 (Bosal) in which it held that a former tax provision that subjected a deduction of interest expenses related to the financing of a participation to the requirement that the participation derived from Dutch-source taxable profits was incompatible with EU law. The mismatch between deductible expenses and non-taxable profits does not arise under the other DTR mechanisms which provide for DTR on a net basis. For a further outline of the ‘Bosal mismatch issue’, see Janssen et al., *supra* note 18.

⁷⁵ Note that the Dutch thin-capitalization rules of Article 10d Dutch CITA, which had been introduced to mitigate some of the negative effects of the Bosal mismatch, have been abolished for fiscal years starting on or after 1 January 2013.

⁷⁶ Article 13l Dutch CITA. Under the new rule, the taxpayer is deemed to have a debt relating to the financing of a participation to the extent that the average cost price of its participations exceeds its average equity. The interest on the participation debt is not deductible to the extent the amount of interest charged exceeds €750,000. Several exceptions apply.

⁷⁷ European Commission, Staff working paper, *The internal market: factual examples of double non-taxation cases – Consultation document*, Brussels TAXUD D1 D(2012).