‘Sharing the Pie’;

Taxing multinationals in a global market

Maarten Floris de Wilde

‘Sharing the Pie’;
Taxing multinationals in a global market

Over het belasten van multinationale ondernemingen in een globale markt

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‘Sharing the Pie’;
Taxing Multinationals in a Global Market

By Maarten Floris de Wilde

To Ciska, my love

Preface

Most stuff from the 1920s sits in museums – the exception is the international tax regime

The current international corporate tax regime for taxing the business proceeds of firms operates arbitrarily. The aggregates of the nation states' international corporate tax systems seem to distort a global efficient allocation of resources.

The current model of corporate taxation finds its origins in the 1920s. It well suited the economic realities of the early days of international trade and commerce; the times when international business primarily revolved around bulk trade and bricks-and-mortar industries. But those days are long gone. Globalization, European integration, the rise of multinational enterprises, e-commerce, and intangible assets have changed the world considerably.

These developments have caused the model to operate inconsistently with the economic reality of today. Corporate taxation and economic reality are no longer aligned. The model is ill-suited to current market realities. As a result multinational business decisions are distorted by tax considerations. The arbitrage may work to the benefit or detriment of nationally and internationally active firms. It also seems to put pressure on nation state corporate tax revenue levels. This may lead to spill-over effects and welfare losses at the end of the day. Matters seem to worsen in today's increasingly globalizing economy.

The question arises as to whether a proper alternative for taxing multinationals can be modeled. How should business proceeds of multinationals be taxed? Can we create something that suits the nature of a global marketplace somewhat better? What would such an alternative tax system look like? How would it operate?

This study seeks to set forth an alternative to the corporate taxation framework currently found in international taxation. The aim is to develop some building blocks for an optimal approach towards taxing the business proceeds of multinationals, i.e., a 'corporate tax 2.0'. As a starting point the authority of currently applicable national, international, and European tax law are not necessarily accepted. Accordingly, applicable tax law serves illustrative rather than argumentative purposes in this research.

There are many people I wish to thank. This dissertation would not have been completed without the support and help that I received during the process of preparing the manuscript. Some I should mention explicitly.

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Furthermore, I would like to express my thanks and appreciation to my PhD supervisor, Professor Ton Stevens, for the hours spent on reading the draft manuscript and for taking the

time to discuss the observations and findings, particularly in the final stage of the research process. And Ton, thanks again for sharing your insight, allowing me to further simplify the advocated system mathematically in Chapter 6. I am also indebted to my former supervisor at Utrecht University, Geerten Michielse, for encouraging me to pursue the real argument rather than the authority argument to base my reasoning upon. Thanks Geerten for providing me the tool to widen the framework of my thinking.

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And finally my family, and, of course, Ciska, my love. Cis, thank you for your love, your infinite patience, and your advice; and thank you, for being you, and for being there.

Maarten de Wilde, Utrecht, 1 January 2015

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1.1 Introduction; the issue[1]

1.1.1 The territorially restricted fiscal sovereignty in an era of globalization calls for an international tax regime

We live in an era of globalization. An increasingly borderless global economy has emerged in which production factors almost effortlessly flow across country borders – particularly in the larger production regions. Domestic markets have gradually opened up, steadily evolving into a single worldwide marketplace.[2] The resulting opening up of domestic markets, business opportunities and competition have created an environment in which profit maximization-driven multinational enterprises have been able to thrive and to become the players dominating international trade and investment today.[3]

Most nation states have facilitated these processes of cross-border market integration, as free and fair trade and competition are widely considered to foster economic growth, optimizing welfare and prosperity. The various trade agreements in place promoting free cross-border flows of production factors and products may be considered noteworthy examples in this respect. One of the most notable legal frameworks facilitating cross-border economic activity perhaps is that of the European Union. Within the context of the European Union, the Member States have created a legal, even an institutional framework, to facilitate both formally and substantively the integration of the Member States' domestic markets into a single internal market without internal frontiers.

While domestic markets have integrated and internationalized, the corporate tax systems of countries have essentially remained a domestic matter. The fiscal sovereignty of the nation state is a national affair. This also holds true within the European Union, where the competence to levy direct taxes has remained at the level of the individual Member States. The term fiscal sovereignty here refers to the sovereign right of a nation state to levy tax – i.e., the revenue side of fiscal policy – for the purpose of financing the public goods it provides to society – i.e., the expenditure side of fiscal policy.[4] The fiscal sovereignty is a quintessential property of a nation state. It is the instrument through which it expresses its function of redistributing individual well-being to optimize the collective well-being of its population.[5] Without this power of the purse, a state cannot function; perhaps even be considered not to exist at all.

Consequently, the corporate tax on the proceeds that multinationals derive from their cross-border investments needs to be shared. Corporate tax revenues are to be divided between

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[1] This chapter draws from and further builds on Maarten F. de Wilde, 'Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy', 38 *Intertax* 281 (2010). Some paragraphs have been drawn from Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

[2] See Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment*, (2008), at 11.

[3] See e.g., Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823, at 826 (2002), and Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 5-17. Abdallah and Murtuza refer to the changes in the way multinationals conduct international business, i.e., from the traditional way on a country-by-country basis to the adoption of new global business models such as e-commerce and shared services or intangible assets.

[4] See Reuven S. Avi-Yonah et al, *Comparative Fiscal Federalism – Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence (EUCOTAX Series on European Taxation)* (2007), at 1. See also Reuven S. Avi-Yonah, 'The Three Goals of Taxation', 60 *Tax Law Review* 1 (2006-2007). Further to the revenue raising and wealth redistribution functions Avi-Yonah also recognizes a third function of taxation: taxation as a tool or instrument to steer taxpayer behavior. I understand the possibility of tax to be employed as an instrument to drive taxpayer decisions yet do not recognize it as something to be desired, at least not in corporate taxation. In my view, corporation taxes should operate neutrally. Hence, I see no room for an instrumental function in corporate taxation. See for some further analysis Chapter 2 of this study.

[5] See Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapters 1 and 2 and Victor Thuronyi, "The Concept of Income", 46 *Tax Law Review* 45 (1990), at 45-105. See also Reuven S. Avi-Yonah, 'The Three Goals of Taxation', 60 *Tax Law Review* 1 (2006-2007). See Chapter 5 of this study for some analysis of the concept of income in taxation.

nation states; tax burdens are to be distributed among corporate taxpayers. 'Sharing the tax pie'.[6] Nation states cannot neglect each other's sovereign rights to levy tax. The right of nation states to tax business income is effectively limited to business proceeds derived within their geographic territories.[7]

Accordingly, an allocation methodology is required to achieve this objective. A distributive code is needed, a model; an international tax regime.[8] Theoretically, such a model could evolve as the end result of a process where the nation states involved mutually coordinate their tax systems – i.e., an equilibrium through tax coordination. Alternatively, such a model could be the outcome of a process where the nation states involved compete with one another in attracting and preserving economic activity within their territories at each other's expense – i.e., equilibrium through tax competition.

1.1.2 The current international tax regime was developed close to a century ago

1.1.2.1 The regime's purpose: geographically locating profits generated

Under the current international tax regime, the nation states seeking to tax corporate income basically all try to geographically tie down a multinational firm and the profits it generates or the value it adds through any investments in the respective taxing state's territories.[9] For this purpose, all nation states have established a tax jurisdiction concept to geographically determine a firm's economic presence and, accordingly, its taxable presence ('nexus'). And all nation states have subsequently established a method to calculate the income the respective firm derives at that geographic location ('allocation'); that is, to geographically attribute the profits of the firm to the territories of the respective taxing state who may subsequently effectively subject these profits to corporate tax.

In essence the international corporate income and capital gains tax systems – hereinafter the international tax systems – of basically all modern democratic constitutional states share this objective. And basically all nation states worldwide to some extent utilize the same approaches to that end.[10] By international tax system of a state I mean the aggregate of its national income and capital gains tax system and its network of double tax conventions. With respect to the Member States of the European Union these aggregates of domestic tax laws and double tax convention networks are placed within a framework of supranational European

[6] The reference to the 'sharing of the tax pie' has been taken from Nancy Kaufman, 'Fairness and the Taxation of International Income', 29 *Law and Policy in International Business* 145 (1998), at 153.
[7] See Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination*, (1984) 228, at 230 referring to *"the notion that jurisdictions are entitled to tax the value added within their borders including that by non-resident factors, that is to share in the income accruing to non-resident factors and earned by them within the geographical area."* See for a comparison Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), referring to Musgrave at 27.
[8] The term 'international tax regime' has been taken from Reuven S. Avi-Yonah, *International Tax as International Law; An Analysis of the International Tax Regime* (2007), at Chapters 1 and 10.
[9] See the Communiqué of the G20 Meeting of Finance Ministers and Central Bank Governors in Moscow of 19-20 July 2013, at par. 18*: "Profits should be taxed where functions driving the profits are performed and where value is created."* See also Arnaud de Graaf, Paul de Haan and Maarten de Wilde, 'Fundamental Change in Countries' Corporate Tax Framework Needed to Properly Address BEPS', 42 *Intertax* 306 (2014), at 308. Further, see OECD*, Action Plan on Base Erosion and Profit Shifting,* OECD Publishing, 19 July 2013, at 20: *"Assure that transfer pricing outcomes are in line with value creation,"* and Yariv Brauner, 'BEPS: An Interim Evaluation', 6 *World Tax Journal* 10 (2014), referring to that remark of the OECD at 32 and 38. At 38: *"[f]or transfer pricing, the OECD has (unprecedently) produced what sounds like a principle: allocation of tax base according to value creation."* See also Peggy. B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination*, (1984) 228, at 228-246, Irene J.J. Burgers, 'Some Thoughts on Further Refinement of the Concept of Place of Effective Management for Tax Treaty Purposes', 35 *Intertax* 378 (2007), Brian J. Arnold, 'Threshold Requirements for Taxing Business Profits under Tax Treaties', 57 *Bulletin for International Taxation* 476 (2003) and Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006), at 266-280. On profit allocation, see OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010. For some analysis, see Danny Oosterhoff, 'The True Importance of Significant People Functions', 15 *International Transfer Pricing Journal* 68 (2008).
[10] See OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing, 12 February 2013, at Chapters 1, 4 and 5.

Union law in scenarios falling within the scope of application of the Treaty on the Functioning of the European Union.

1.1.2.2 The building blocks of a typical corporate tax

Tax jurisdiction: nationality, domicile, and source

The key attributes of the international tax systems of states are the following. To establish tax jurisdiction countries typically make use of taxation principles based on nationality, domicile, and source. These principles, respectively the 'nationality principle', the 'residence principle', and the 'situs principle' are used to identify the multinational firm's economic presence within a country and to establish its taxable presence accordingly ('nexus').

In corporate taxation, the nationality of corporate bodies is typically determined by reference to the company laws applicable in the countries governing the legal capacities of the legal entities involved.[11] Corporate residence and source are generally determined by reference to the physical-geographical concepts of 'place of effective management' and 'permanent establishment' – i.e., with regards to the latter defined as the fixed place of business through which the taxpayer carries on its business activities.

Limited tax liability, unlimited tax liability and juridical double tax relief

The concepts of nationality, residence and situs not only constitute the basis for establishing tax jurisdiction, typically the respective corporate taxpayers' scope of its liability to corporate taxation is subsequently also based on these concepts.[12] By applying the principles of nationality and residence it is determined which taxpayers qualify as resident corporate taxpayers. Resident taxpayers generally are taxed on their worldwide corporate earnings – the 'unlimited tax liability'. The application of the source principle results in the recognition of non-resident corporate taxpayers. Non-resident taxpayers are typically taxed on the corporate earnings that they realize within the territories of the respective taxing state – the 'limited tax liability'.

In general the state of residence ensures that foreign source income is not effectively taxed twice by providing double tax relief – the 'elimination of double taxation'. The mechanisms commonly applied in practice are the 'direct (ordinary) credit' for foreign tax and the 'base exemption' for foreign income.[13] The source state typically does not subject the foreign source income items of non-resident taxpayers to corporate taxation. These mechanisms effectively seek to ensure that business income is taxed only once.

Separate entity approach for tax entity definition purposes

The taxable entities in corporate taxation, the corporate taxpayers, are corporate bodies. Typical examples of taxable corporate bodies are publicly and privately held limited liability companies. Partnerships are generally regarded as transparent for tax purposes and each partner will be subject to corporate income tax or individual income tax for their share of the partnership's income, unless an exception applies. Some countries consider limited liability

[11] To identify a corporation's nationality typically two approaches taken may be distinguished, the incorporation seat system and the real seat system. Under an incorporation seat system a corporate entity's legal capacities are governed by the company laws under which the respective entity has been incorporated. Under a real seat system a corporate entity's legal capacities are governed by the company laws applicable in the jurisdiction in which the corporate body governing the respective entity is effectively situated. See for some further analysis Chapter 6 of this study.

[12] The income taxation of individuals is left out of consideration in this study. The same holds for the (inter)relationships between a corporate income and capital gains tax on the one hand and an individual income and capital gains tax on the other.

[13] The Netherlands' international tax system makes use of an alternative double tax relief mechanism in the area of individual income taxation. The mechanism is commonly referred to in tax practice as a tax exemption with progression. It however conceptually operates as a credit mechanism. More specific, the relief mechanism provides for a credit that is equal to the amount of domestic tax that is attributable to foreign income. This double tax relief methodology is extensively explored in Chapter 3 of this study.

companies tax transparent and in some countries tax transparency is optional. Other countries treat partnerships or limited partnerships as corporate taxpayers. It differs greatly depending on the country involved.

To identify the taxable entity for corporate taxation purposes it is often relevant whether the legal entity involved has legal personality – i.e., the capacity to own property and to conclude legal transactions –; whether its equity capital is divided into shares, whether the participant's liability for the entity's debts is limited, and whether the participant may publicly trade its corporate interest – i.e., without the consent of its fellow participants. If the answers to these questions are affirmative, the legal entity typically qualifies as a corporate body and its corporate tax liability subsequently follows on from this. However, in the end, clear lines often cannot be drawn. And it may be difficult to decide when exactly a corporate entity constitutes a corporate body and hence a taxpayer for corporation tax purposes. No legal paradigm exists in this area.

Typically, the approach of subjecting corporate bodies to corporate taxation as separate taxable entities is followed regardless of whether the corporate bodies involved are part of a functionally integrated multinational firm. This is particularly true in cross-border environments. Notably, permanent establishments are hypothesized to be separate enterprises for profit allocation purposes, distinct from the taxable corporate body of which it legally forms part. The approach taken of taxing corporate bodies individually is generally referred to as the '(functionally) separate entity approach', or the 'classical system' of corporate taxation.

Realized nominal return to equity for tax base definition purposes

The taxable base in corporate taxation is typically defined by reference to a realization-based nominal return to equity standard.[14] This holds true for the corporate tax systems of most countries. Again, save for some exceptions. A key feature of the nominal return to equity standard is the difference in deductibility for tax purposes of remunerations paid for the provision of the capital involved. The tax-deductibility depends on the question as to whether the means provided qualify as debt capital or equity capital for tax purposes. The remuneration paid for raising debt – interest – constitutes a tax-deductible item. The remuneration paid for raising equity capital does not; dividends generally are not tax-deductible.[15]

Tax base allocation; separate accounting and arm's length standard

As regards the geographic division of the corporate tax base, the basic objective is to allocate corporate profits to the firm's investment location. The allocation mechanism is built on legal constructs and fictions. The separate entity approach that is used to identify the taxable entity has the effect that legal transactions undertaken by taxable legal entities are recognized for tax allocation purposes, also when these transactions are undertaken within a multinational firm in a cross-border environment. As a result, cross-border legal transactions undertaken between affiliated corporate entities are recognized for tax base allocation purposes (intra-firm inter-entity legal transactions). In cross-border environments even fictitious legal constructs may be recognized for this purpose. So-called internal dealings are constructed to geographically divide the profits of a single taxable corporate body between the permanent establishment and the head office (intra-firm intra-entity transfers). The approach of recognizing intra-firm modes of transfers for tax base division purposes is generally referred to as 'separate accounting' ('SA').

[14] See e.g., Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448, and Serena Fatica et al, 'Taxation Papers; The Debt-Equity Tax Bias: Consequences and Solutions', *European Commission Directorate-General Taxation & Customs Union* 2012:33.
[15] See on this matter, e.g., *The debt-equity conundrum*, Cahiers de droit fiscal international vol. 97b, International Fiscal Association, Sdu Fiscale & Financiële Uitgevers, Amersfoort, The Netherlands, 2012, and Serena Fatica, Thomas Hemmelgarn, and Gaetan Nicodeme, Taxation Papers; *The Debt-Equity Tax Bias: Consequences And Solutions*, Working paper no. 33, July 2012, European Commission Directorate-General Taxation & Customs Union.

As intra-firm modes of transfers are recognized for corporate tax base division purposes, the proceeds from these intra-firm dealings need to be distributed amongst the affiliated taxable entities of the firm. These intra-firm transfers need to be priced. The transfer price is based on a fiction which is referred to as the 'arm's length principle' or the 'arm's length standard' ('ALS').[16] A transfer price is established for intra-firm transactions and equivalent dealings as if the affiliated entities are third parties. In the end, the arm's length transfer price is determined by reference to the physical-geographical concept of 'significant people functions'.[17] The objective of this concept is to ultimately allocate business income to the place where the individuals relevant to the business enterprise actually perform the business activities of the multinational firm.[18] This approach is generally referred to and abbreviated as SA/ALS.

Correction mechanisms; group regimes

In the event that the corporate income allocated does not correspond to economic realities or is otherwise considered inappropriate by the taxing states involved, various correction mechanisms have been put in place. Examples of such correction mechanisms are 'tax-consolidation regimes', or 'profit-pooling regimes' for groups of affiliated companies to appreciate the reality of the firm to constitute a single economic entity. These regimes regard the firm as a single unit, regardless of its legal organization. These tax-grouping regimes however typically do not apply across the tax-border of the respective taxing jurisdiction. Other common examples of correction mechanisms seeking to adjust the effects of the chosen system to appreciate economic realities are the so-called economic double tax relief mechanisms such as 'indirect credit regimes' and 'participation exemption regimes'. These mechanisms and regimes apply with respect to proceeds from intra-firm or inter-firm equity interests, such as dividends and capital gains on shareholding disposals. The purpose of these mechanisms is to mitigate the economic double taxation that the classical system of corporate taxation initiates.

Correction mechanisms; anti-abuse regimes

Furthermore, one may also think of the anti-abuse measures typically used by high-tax jurisdictions to counter the artificial shifting of corporate profits by multinationals to low tax jurisdictions – 'sticks regimes'. These anti-abuse measures commonly apply to tax-recognized income streams involving intra-group distributions of financial resources or intellectual property lacking underlying economic substance, That is because these resources are internationally mobile and easily transferred legally within a multinational group of affiliated corporate bodies. Furthermore, intra-firm income streams are generally tax-deductible at the level of the payee group company in the country in which real investment takes place.

The anti-abuse measures may be of a general non-targeted nature and operate as such. They typically apply irrespective of legal arrangements and firm resources utilized for tax avoidance purposes. Examples of general anti-abuse mechanisms include the concept of 'fraus legis' that applies in various countries, and the abuse of law doctrine in place, e.g., under European Union law. These measures seek to counter artificial legal arrangements set up to avoid tax. For instance, tax-deductions, source tax reductions or tax shelters sought under such an artificial arrangement may be disregarded in the investment country by substituting the inter-affiliate legal transaction for corporate tax purposes and by the tax effect as sought under the legislative tax act's object and purpose.

[16] The arm's length principle is a fiction as it assumes that the intra-group transfer price is set *as if* the affiliates are unrelated (i.e. third parties). However, the economic reality is that the activities take place within the multinational ('in-house'). The decision to keep the activities in-house is based on economic considerations. This reality is ignored under the arm's length principle. See for some analysis Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286, Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', 62 *Bulletin* for *International Taxation* 201 (2008), at 201-215, and Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 103-111. This issue is dealt with extensively in Chapter 6 of this study.

[17] See OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

[18] See for extensive analyses Chapter 6 of this study.

Anti-abuse measures may also be designed to apply in certain specific cases. These measures have in common that they seek to ensure single taxation in line with economic realities in the country in which the multinational firm has actually invested. Examples of such targeted anti-abuse measures are 'subject-to-tax clauses' and 'switch over from exemption to credit mechanisms'. These typically apply where corporate taxpayers derive income sourced in foreign tax jurisdictions who subject these proceeds to low or no taxation. A second example is the use of anti-deferral legislation ('controlled foreign company', or 'CFC'). The CFC rules apply to situations in which passive income is sheltered in controlled foreign subsidiary companies that are subject to low or no taxation in their countries of tax residence. A third example is the use of interest deduction limitations, such as 'earnings stripping' and other 'thin-capitalization measures'. These measures apply where corporate taxpayers take out intra-group or other loans producing tax-deductible interest payments to levels that are considered inappropriate by the respective tax jurisdictions involved ('base erosion'). Furthermore, one may think of the concepts of economic and beneficial ownership ignoring legal realities for corporate tax purposes in certain specific cases – the 'substance over form approach'. These measures may apply where corporate taxpayers seek to divert income streams through controlled intermediate subsidiaries, so-called 'conduits', to benefit from source tax rate deductions available under the treaty convention networks of the country of the conduit's tax residence – 'tax treaty shopping'.[19]

Harmful tax measures

At the other end of these anti-abuse measures lie the beneficial tax regimes that are typically used by low-tax jurisdictions – 'tax havens' – to artificially attract corporate profits to their jurisdictions – 'carrots regimes'.[20] Low or no-tax jurisdictions may make use of measures under which intra-firm corporate activities lacking economic substance receive a beneficial tax treatment persuading multinationals to artificially shelter corporate profits in their territories. These measures basically have in common that the aforementioned intra-firm income streams remain untaxed at the level of the recipient group company situated in the respective no or low-taxing jurisdiction.

These tax shelters attracting corporate resources are typically utilized at the expense of the tax jurisdictions in which the actual investments have been made as the income streams generated are generally tax-deductible at the level of the payee group company but not taxed

[19] See on this matter, OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Preventing the granting of treaty benefits in inappropriate circumstances*, OECD Publishing, Paris, 16 September 2014, OECD, OECD Committee on Fiscal Affairs, *Public Discussion Draft BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances, 14 March 2014 – 9 April 2014*, OECD Publishing, Paris, 2014, as well as International Monetary Fund, *IMF Policy Paper; Spillovers in International Corporate Taxation*, International Monetary Fund, Washington, D.C., 2014, at 28-34, and, e.g., Paulus Merks, 'Dividend Withholding Tax Planning Techniques: Part 1', 39 *Intertax* 460 (2011, No. 10), at 460-470, and Paulus Merks, 'Dividend Withholding Tax Planning Techniques: Part 2', 39 *Intertax* 526 (2011, No. 11), at 526-533. Some of those source countries, a notable example of which is India, address the matter by introducing anti-abuse rules seeking to tax the capital gains derived on the disposals of the shareholdings held by the higher tier group entities in those interposed conduits. This practice attracts treaty interpretation issues as the host state involved makes use of a 'look-through' approach upwards in the corporate legal structure to tax the indirect corporate shareholder on the capital gain derived. As a general rule, however, under tax treaty law capital gains are taxable exclusively in the home state of the corporate investor. See on the matter Marc M. Levey, et al, 'Vodafone: An Analysis under Internationally-Recognized Tax Principles', 40 *Intertax* 477 (2012, No. 8/9), at 477-484.

[20] See on this subject, e.g., OECD, *Harmful Tax Competition: An Emerging Global Issue*, OECD, Paris, 1998, OECD, and OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*, OECD Publishing, Paris, 16 September 2014. See on the matter also the Commission's *'December Package'*, i.e., its communication to the European Parliament and the Council entitled *'An Action Plan to strengthen the fight against tax fraud and tax evasion'*, (COM(2012) 722 final, its recommendation on aggressive tax planning (c(2012) 8806 final), and its recommendation regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters (c(2012) 8805 final), which the Commission released on 6 December 2012. Further, see the Commission's press release entitled *'Clamping down on tax evasion and avoidance: Commission presents the way forward'* (IP/12/1325). The package followed up on the communication from the Commission to the European Parliament and the Council on concrete ways to reinforce the fight against tax fraud and tax evasion including in relation to third countries (COM(2012) 351 final) of 27 June 2012. For some analysis and reading see Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

in the hands of the recipient group company based in the low-tax jurisdiction. Accordingly, such practices are widely considered to constitute an inappropriate means for tax jurisdictions to compete with one another for the taxable proceeds from corporate investment.

Under such 'harmful tax measures' or 'predatory regimes' intra-group distributions of financial resources or proceeds from intellectual property are typically subject to a low level of tax or no tax at all. These types of money flows are mobile and easily transferred legally within a group. Harmful tax regimes are often referred to in practice as 'offshore regimes', 'group financing regimes', 'headquarter regimes', 'captive insurance regimes', 'flow-through regimes', or 'intellectual property holding regimes'. Sometimes these regimes go hand in hand with taxpayer confidentiality mechanisms on the basis of which the low-tax jurisdictions involved do not disclose tax-relevant administrative and financial information to other jurisdictions. Furthermore, the availability of such beneficial regimes is often restricted to foreign investors. They are 'ring-fenced'. Local investors are often ineligible to opt for their application.

Tax jurisdictions sometimes decide to make use of harmful tax regimes to foster growth of their domestic economies. Tax jurisdictions may particularly resort to the use of tax shelters when their economic potential is very moderate given their limited size, remote geographic location, or lack of natural resources.

Beneficial tax regimes

Furthermore, some taxing jurisdictions also seek to compete for mobile actual investments and corporate profit by granting beneficial tax treatment to proceeds from investments in intellectual property, transportation, or production in their territories. The incentives that such 'production tax havens' provide to such mobile direct investment activities are sometimes referred to as 'tax holidays' and 'patent box regimes'.[21] The incentives granted typically relate to certain types of direct investment proceeds, such as manufacturing or research and development (R&D) activities.

'Tax free zones' or 'low-taxed economic zones' may be put in place where the countries involved seek to attract direct investments to certain pre-designated areas within their territories.[22] The award of such tax incentives to attract mobile direct investment triggers tax competition and fiscal state aid issues that may even be considered illegal where European Union law applies.[23]

And finally the tax rate

[21] The term 'production tax haven' has been taken from Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000), at 1589. For explanation of the economic 'raison d'etre' of tax holidays, see Chris Doyle et al, 'Taxation of Foreign Multinationals: A Sequential Bargaining Approach to Tax Holidays', 1 *International Tax and Public Finance* 211 (1994, No. 3), at 211-225. See also the recent OECD briefs to G20: *Part 1 of a Report to G20 Development Working Group on the impact of BEPS in Low Income Countries*, OECD, Paris, July 2014, and *Part 2 of a Report to G20 Development Working Group on the impact of BEPS in Low Income Countries*, OECD, Paris, August 2014. For an analysis of preferable corporation tax regimes in South East Asia and some suggestions forwarded to resolve the entailing tax competition issues through tax coordination at the level of the Association of South East Asian Nations, see Adrianto Dwi Nugroho, 'Tickets to Ride: The Race for Preferable CIT Regimes Towards ASEAN Economic Community', 40 *Intertax* 531 (2012, No. 10), at 531-539. On the recent spread of IP-boxes, see International Monetary Fund, *IMF Policy Paper; Spillovers in International Corporate Taxation*, International Monetary Fund, Washington, D.C., 2014,at 21. For some analysis of whether public funds should support R&D activities, see Åsa Hansson et al, 'Tax Incentives, Tax Expenditures Theories in R&D: The Case of Sweden', 6 *World Tax Journal* 168 (2014), at 168-200.

[22] See, Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000), at 1588.

[23] For some further elaboration, see Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38. See on the matter also Michel Aujean, 'Tax Competition and tax Planning: What Solution for the EU', 23 *EC Tax Review* 62 (2014), at 62-63. Worth noting is that the European Commission views the patent box regime in place in the United Kingdom's international tax system as harmful tax competition. See European Commission, Code of Conduct Group (Business Taxation), *UK – Patent Box*, Room Document # 2 of 22 October 2013. It considers that 'the advantages under the regime are granted even without any real activity and substantial economic presence in the Member State involved'. It further considers that 'the rules for profit determination do not adhere to internationally accepted principles.' Moreover, the European Commission is currently in the process of assessing the Luxembourg 'intellectual property tax regime'; European Commission, Press release, IP/14/309, Brussels, 24 March 2014. For some reading and analysis of the Luxembourg regime, see Frank van Kuijk, 'The Luxembourg IP Tax Regime', 39 *Intertax* 140 (2011, No. 3), at 140-145.

The corporate tax payable on the business income thus allocated is finally determined by applying the corporate tax rate to that taxable business income. This wraps-up the 'tax-pie-sharing' process in international taxation.

1.1.2.3 The success of the 1920s Compromise

The basis for the current international tax regime was developed close to a century ago, back in the 1920s and is therefore commonly referred to as the '1920s Compromise'.[24] In these early days of international taxation the League of Nations, as the 'predecessor' of the United Nations and the OECD, drafted the first Model Tax Conventions on Income and Capital.

The 1920s Compromise was founded on best practices and political compromises, rather than principles. However, the outcome of the compromise adequately suited the economic realities of the early days of international taxation. International trade, for instance, consisted largely of bulk good trading the prices of which were set at the global commodity markets. The readily availability of global commodity prices enabled the application of the arm's length principle to geographically divide corporate profit among affiliated corporate bodies and between permanent establishments and head offices in cross-border business scenarios. Furthermore, the successful engaging into business activities in those days required the establishing of a physical presence in the taxing jurisdiction to be able to service its local market. Firms needed to set up places of management, stores, factories, storage facilities and the like to serve the local customer. This may explain the decision to resort to a physical presence for tax jurisdiction purposes to determine the geographical source of the firm's business income on the basis of the place of effective management and permanent establishment.

The 1920s Compromise has been a tremendous success story. Virtually all current international tax systems of the democratic constitutional nation states in the world are based on it. Also, it is likely that the compromise will have a great impact on the direction in which international taxation will develop in the future or near future.[25]

1.1.3 The international tax regime has become outdated and flawed

1.1.3.1 The international tax regime has become outdated

As said, the international tax regime that the 1920s Compromise has brought about was and is still based on practices and political compromise. Practice rather than principle directed the design of the international tax regime.

Should we be bothered? Perhaps yes, as we pay a price. The aggregate of the international tax systems of states, the international tax regime, provides for a model that suited the economic realities of the early days, that is the times in which international business revolved around bulk trade and bricks-and-mortar industries. However, globalization, European integration, the rise of multinationals, e-commerce, and intangible assets have changed the world considerably.

Internationalization has had its effects. The present international tax regime arbitrarily affects corporate tax burdens imposed on corporate investment proceeds and hence the corporate tax revenue levels.[26] The current system distorts business decisions as corporate tax burdens differ by investment type, geographic location, financing, and the way in which the firm has

[24] See Peter Harris et al, *International Commercial Tax* (2010), at 19 and for some historical notes Sunita Jogarajan, 'Stamp, Seligman and the Drafting of the 1923 Experts' Report on Double Taxation', 5 *World Tax Journal* 368 (2013), at 368-392.
[25] See OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing, 12 February 2013, and OECD*, Action Plan on Base Erosion and Profit Shifting,* OECD Publishing, 19 July 2013.
[26] See OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing, 12 February 2013. See also Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at section 2.2.4.

legally organized its investments internally. Multinationals are typically subject to a differential corporate tax treatment dependent on the types of business activities they engage in or the question whether they finance their operations internally or externally with debt capital or equity capital. Furthermore, the tax treatment generally artificially differentiates between a firm's legal organization of its business operations via a branch structure or a subsidiary structure.[27]

1.1.3.2 The international tax regime has become to operate arbitrarily as a consequence

As the effective corporate tax burdens imposed arbitrarily vary depending on the ways in which economic operators have arranged their affairs, corporate taxation affects business decisions. At the end of the day the corporate tax payable differs depending on the answers to questions such as 'Do we sell our products through a physical store or a virtual web store?'; 'Do we setup a branch or a subsidiary to service that market?'; 'Do we structure our business by incorporating a taxable subsidiary company or shall we use a tax transparent partnership?'; and 'Do we finance our business operations with external or intra-group debt or equity capital?' Conceptually the answers to these questions should be of no relevance to the actual tax burden. But since they do, corporate taxation proves to be a distortive factor in the business process.

Moreover, international tax systems typically subject economic operators to different corporate tax treatment dependent on whether business is carried on in a cross-border or a purely domestic context. For instance, countries may subject taxpayers to different tax burdens depending on their corporate nationality and corporate residence. This triggers direct discrimination issues and indirect discrimination issues; a nationality or residence should be of no relevance in determining the tax burden. A taxing country may also subject a taxpayer to a different tax burden depending on whether its income is generated within several tax jurisdictions or solely within a single tax jurisdiction. The tax burden imposed may differentiate dependent on the investment direction. The inbound or outbound movement of the respective investment often affects the tax burden that is imposed on the investment returns. This triggers jurisdiction entry restrictions issues and jurisdiction exit restrictions issues.

The differentials in the tax treatment arising from the crossing of borders by investors and investments obviously affect the economic decisions of economic operators whether or not to cross the tax-border. Taxation also affects the business decision of an economic operator as to whether or not direct investment across the tax-border. Problems may, for instance, arise where cross-border tax grouping is not allowed while tax-groups may be formed within a single tax jurisdiction. Issues may also arise where foreign source losses may not be offset against domestic source profits while corporate bodies may setoff losses and profits derived from domestic sources only.[28]

The arbitrary tax differentials in the international tax regime cause investment location distortions as they affect the geographic distribution of the production factors capital, labor and enterprise. In individual cases things may work out to the benefit or detriment of individual multinationals or tax administrations. Well-advised multinationals may even be able to change the jurisdictional allocation of their business income for tax purposes to their benefit without substantially altering their underlying investment. Through a clever legal structure of their business activities their taxable corporate profits may be artificially shifted to the comparatively lower tax jurisdiction ('tax optimization'). Accordingly, multinationals may influence their effective average tax rates in the countries in which they are economically active.

[27] See e.g., Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 8.
[28] Cf. Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 7.

It is no secret that statutory corporate tax rates and the effective tax burdens imposed on the profits of multinationals often do not align. As the process of globalization proceeds, an increasingly greater gap seems to emerge between statutory tax rates and effective tax burdens; sizeable parts of the multinationals' global earnings may effectively escape corporate taxation as the current tax consultancy practice sometimes shows.[29] Also, the arbitrary tax differentials may affect corporate tax revenues accordingly.[30]

1.1.3.3 The international tax regime has become unfair

The arbitrage in the international tax regime exerts great pressure on the international tax systems of states. Observed as a whole, it may be said that the aggregate of international tax systems of the states distorts the proper functioning of domestic markets, the internal market within the European Union and the emerging global market. Corporate taxation basically comes apart at all seams.[31] This may be considered problematic, not only in terms of fairness but also in terms of the countries' abilities to collect corporate tax revenues.

It seems that the international tax regime can be employed for one's own benefit if one knows its way around in the tax toolkit.[32] Indeed, this could prove beneficial to multinational firms at micro-level. However, if observed from a macro-perspective the arbitrariness of the international tax regime may ultimately prove problematic for all parties involved, both for the taxpayers and for the taxing states. In the end, it is necessary to raise revenues through taxation to finance public expenditure. If countries encounter structural and perhaps even insurmountable difficulties in raising revenues from taxing the proceeds from cross-border business activities in the long run, it may even be impossible to uphold the welfare state; in the end the arbitrage may even result in welfare losses.[33] Perhaps, everyone ends up paying the price of a flawed international tax regime at the end of the day.

Several tax scholars have concluded that the model that resulted from the 1920s Compromise is poorly equipped nowadays to adequately capture the geographic location of business activities and business income for corporate tax purposes.[34] Somewhere down the

[29] That is, although *"it is difficult to reach solid conclusions about how much base erosion and profit shifting actually occurs"* in practice. See OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing, 12 February 2013, at Chapter 2, also for overviews of corporate tax receipts data.

[30] Cf. Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at section 2.2.

[31] International Monetary Fund, *IMF Policy Paper; Spillovers in International Corporate Taxation*, International Monetary Fund, Washington, D.C., 2014.

[32] *Ibidem*, at 11 for some of the 'Tools of the Trade'.

[33] See for a comparison, e.g., International Monetary Fund, *IMF Policy Paper; Spillovers in International Corporate Taxation*, International Monetary Fund, Washington, D.C., 2014, at 6-14, and European Commission, 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*, COM(2001) 582 final, Brussels, 23 October 2001. See also Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000).

[34] See Michael Lang (ed.), *Source versus Residence, Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives (EUCOTAX Series on European Taxation)* (2008), at 9-21, Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper 07/05*, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), at Chapter 4, Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', 62 *Bulletin* for *International Taxation* 201 (2008), at 201-215, Dale Pinto, 'Exclusive Source or Residence-Based Taxation – Is a New and Simpler World Tax Order Possible?', 61 *Bulletin for International Taxation* 277 (2007), at 277-291, Niv Tadmore, 'Source Taxation of Cross-Border Intellectual Supplies – Concepts, History and Evolution into the Digital Age', 61 *Bulletin for International Taxation* 2 (2007), at 2-16, Eric C.C.M. Kemmeren, 'Source of income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach', 60 *Bulletin for International Taxation* 430 (2006), at 430-452, Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006), at 266-280, Klaus Vogel, '"State of Residence" may as well be "State of Source" – There is No Contradiction', 59 *Bulletin for International Taxation* 420 (2005), at 420-423, Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 103-111, Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 826, Arthur J. Cockfield, 'The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles', 56 *Bulletin for International Taxation* 606 (2002), at 606-619, Michael J. Graetz, 'The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory

road, the system has become outdated and flawed and arbitrary as a result. The international tax regime has become unfair. And, at the end of the day, we all pay the price for it.

1.1.4 The distortions categorized: 'obstacles', 'disparities' and 'inadequacies'

1.1.4.1 Distortions; the influence of taxation on corporate behavior

The distortions in the international tax systems of states may be analytically categorized in a twofold manner, i.e., by distinguishing between the distortions that occur in relation to the allocation of tax among taxpayers on the one hand and the distortions that occur in relation to the allocation of tax between countries on the other. With the term 'distortion' I mean the influence of the international corporation tax systems of nation states on the manner in which multinationals actually and legally arrange their business affairs.[35]

1.1.4.2 Arbitrary allocation of tax to taxpayers: 'obstacles' and 'disparities'

First, distortions occur in relation to the allocation of tax to taxpayers. The tax burden on business income differs depending on whether or not the economic operator conducts its business activities in a cross-border environment. This difference is ultimately caused by the fact that fiscal sovereignty rests with the respective sovereign states. Effectively, there is little coordination between countries in tax law design. Today, there is no supranational body that is competent to coordinate the levy of direct taxes. This category of distortions may be divided into two subcategories: 'obstacles' and 'disparities'.[36]

'Obstacles' arise where the international tax systems of countries unilaterally treat cross-border business activities differently from non-cross-border (i.e., domestic) business activities for tax purposes.[37] These differences in tax treatment may hinder or promote cross-border investment relative to domestic investment by subjecting business proceeds to comparatively higher or lower tax burdens dependent on the location of the investor or its investment. The distortive different tax treatment is imposed by a nation state unilaterally. The difference in tax treatment of domestic and cross-border economic activity occurs within the tax system of a single state. Obstacles are a problem internal to the international tax system of a state.

The obstacles in the international tax system of a country affect the decisions of economic operators in that they may wish to direct, redirect or locate themselves or their economic operations across-tax borders, since the tax burden imposed unilaterally by states may differentiate as a consequence of such a decision. The tax burden unilaterally imposed may be comparatively higher or lower relative to the equivalent domestic scenario.

Policies', 54 *Tax Law Review* 261 (2001), at 261-336, Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286, and Reuven S. Avi-Yonah, 'The Structure of International Taxation: A Proposal for Simplification', 74 *Texas Law Review* 1301 (1996), at Chapter 3. See also Yariv Brauner, 'BEPS: An Interim Evaluation', 6 *World Tax Journal* 10 (2014), at 16.

[35] On the subject of tax induced distortions in business decisions, see Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission, Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264. Notably, the authors argue the likeliness of corporate profits being more mobile than corporate resources implying that the shifting of profits between taxing jurisdictions occurs to a greater extent than the shifting of real economic activity. See also Harry Huizinga et al, 'International profit shifting within multinationals: a multi-country perspective', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:260, finding some evidence in support of tax-induced profit shifting.

[36] The terminology used has been derived from the case law of the Court of Justice of the European Union in direct taxation matters. Notably, in my view, the distortions resulting from disparities and obstacles in the international corporate tax systems of states also exist outside the context of the European Union and its Member States. The only difference between the obstacles and disparities in the tax systems of European Union member states and their equivalents in the tax systems of non-European Union member states is that the first mentioned cases fall within the scope of application of the Treaty on the Functioning of the European Union while the latter mentioned do not. It follows that in the latter cases no supranational body is in place that is legally enabled to resolve these tax-induced distortions in the allocation of business resources. This, however, does not mean that such distortions are absent in the international tax systems of non-European Union Member States. They are present indeed, yet no legal means currently exists to resolve them.

[37] Cf. Frans Vanistendael, 'In Defense of the European Court of Justice', 62 *Bulletin for International Taxation* 90 (2008), at 96, as well as Frans Vanistendael (ed.), *EU Freedoms and Taxation* (2004), at Chapter 1.

In practice, obstacles are imposed by states when economic operators enter, locate investment or exit the domestic markets of these states (restrictions).[38] Moreover, obstacles are imposed when countries tax economic operators differently depending on their nationality ('direct discrimination') or place of residence ('indirect discrimination'). Due to this, internationally active economic operators see themselves hindered or favored when they move out of domestic markets, creating a tax bias relative to those staying at home. The obstacles imposed upon moving into or out of tax jurisdictions distort the functioning of the globalizing economy. Within the European Union, obstacles distort the functioning of the internal market without internal frontiers.[39] When multinationals are confronted with obstacles they may either be unable to work their way around them, or make use of them to their benefit when arranging their business affairs (legally). European Union law seeks to remedy these types of distortions through the application of the fundamental freedoms.

'Disparities' or 'mismatches' – these terms are considered to be synonymous in this research and are used interchangeably – arise where the international tax systems of states mutually diverge from one another. The distortive differences in the tax treatment of cross-border business activities relative to domestic business activities are not caused by states on a unilateral basis – as is the case with obstacles –, but find their origin in the parallel exercise of the fiscal sovereignty by the states concerned.[40] Disparities are a multilateral non-coordination issue.[41]

Disparities result from mutual differences in a country's definition of a taxable entity ('who to tax?'), tax base ('what to tax?'), its tax rates, or any differences in the application of the international tax principles of nationality, source, and residence. A disparity in taxable entities occurs where the respective states concerned treat legal entities differently for tax purposes. This produces so-called 'hybrid entity mismatch' issues.[42] One country may consider an entity tax transparent, while the other does not. Examples of disparities in tax bases include differences involving the deductibility or non-deductibility of expenses, or mutual differences in depreciation schemes. Another example of such a disparity is a difference in the qualification and/or interpretation of facts and circumstances for corporate tax purposes; for example, one state may consider an income item taxable or deductible interest expense, while the other state considers it a non-deductible or exempt dividend distribution. This produces so-called hybrid income issues, 'income mismatches' or 'timing mismatches'.[43] Examples of disparities

[38] The term domestic markets refers to the traditional markets as drawn up alongside the domestic borders of the nation state involved. Notably, in the event that a nation state unilaterally imposes an obstacle, which, however, in practice is neutralized by another state on the basis of the bilateral double tax convention concluded, the obstacle in fact ceases to exist. Cf. Court of Justice, cases C-379/05 (*Amurta*) and C-43/07 (*Arens-Sikken*). See on this matter Frans Vanistendael, 'In Defense of the European Court of Justice', 62 *Bulletin for International Taxation* 90 (2008), at 96. Such a neutralization of an obstacle in an international tax system of one nation state by means of an interconnected opposite measure in the international tax system of another nation state, however, conceptually does not render the obstacle in the first mentioned nation state absent. In my view, an obstacle in a tax system should not be eligible to be sanctioned conceptually by means of such a 'neutralization argument'. This matter is further discussed in Chapter 3 of this study.

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

[40] See Frans Vanistendael, 'In Defense of the European Court of Justice', 62 *Bulletin for International Taxation* 90 (2008), at 96.

[41] See, e.g., OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Developing a multilateral instrument to modify bilateral tax treaties*, OECD Publishing, Paris, 16 September 2014, in which the OECD assesses the feasibility to adopt a miltulateral instrument to amend the existing double tax treaties.

[42] See for some reading and analysis, OECD, OECD Committee on Fiscal Affairs, *Public Discussion Draft BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Recommendations for domestic laws)*, *19 March 2014 – 2 May 2014*, OECD Publishing, Paris, 19 March 2014, OECD, OECD Committee on Fiscal Affairs, *Public Discussion Draft BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Treaty Issues), 19 March 2014 – 2 May 2014*, OECD Publishing, Paris, 2014, and OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Neutralising the effects of hybrid mismatch arrangements,* OECD Publishing, Paris, 16 September 2014. The OECD suggests to amend Article 1 OECD Model Tax Convention to ensure that tax transparent entities are not used to unduly obtain access to the treaty benefits.

[43] *Ibidem.* The OECD recommends countries to adopt so-called 'linking rules' in their domestic rules to counter hybrid mismatch issues. It suggests resolving the matter pragmatically by means of a two-step approach which makes reference to 1) a 'primary linking rule', denying a deduction at the level of the payer entity if the income item involved is not included in the taxable income of the recipient entity, and 2) a 'secondary linking rule' (or 'defensive rule'), denying an exemption (i.e., including the income item in the taxable base) at the level of the recipient entity if the income item involved is tax-deductible at the level of the paying entity. Within the European Union, the Parent-

found in the application of international tax principles include juridical or economic double taxation or the absence of taxation.[44] One state looks at the source for the purposes of subsequently levying its corporate tax, while the other state looks at residence or nationality, or has an alternative interpretation of source, residence or nationality for its domestic corporate taxation purposes. Disparities occur when economic operators move across tax jurisdictions. This distorts the functioning of the globalizing economy and the internal market. Disparities hinder or promote cross-border investment dependent on facts and circumstances relative to domestic investment. That is, by subjecting cross-border business proceeds to comparatively higher or lower tax burdens relative to their domestic equivalents.

Mismatches or disparities in the international tax regime affect the decisions of economic operators. They may wish to direct or redirect money flows or move to or move their operations into a different tax jurisdiction as the tax burden imposed by states in their mutual operation may differentiate as a consequence of such a decision. The tax burden imposed may be comparatively higher or lower relative to the domestic scenario. Mismatches may even entail economic double taxation and double non-taxation.

In practice, multinationals are being accused of employing any disparities or mismatches in the corporate tax systems of countries to their benefit. That is, by using the mismatches in the international tax regime to reduce the overall effective tax burden on their business income without substantially altering their investments. It has been argued that this occurs, for instance, by making use of a so-called hybrid entity or hybrid income structures.[45] In practice these are labeled 'Hybrid Instruments', 'Hybrid Entities', 'Hybrid Transfers', 'Dual Residence Entities', '(Double) Deduction/No Inclusion Transactions', or 'Foreign Tax Credit Transactions'.[46] The common denominator of these 'mismatch arrangements' is that use is made of the disparities in the definition of taxable entity, tax base of a country or its tax base allocation mechanisms, or tax rates.

1.1.4.3 Arbitrary allocation of tax among states: 'inadequacies'

'Inadequacies'; three categories

Second, distortions occur in relation to the allocation of tax between countries. These are caused by the flaws in the international tax regime – the 'inadequacies'. The model of the 1920s Compromise is no longer adequate to allocate corporate tax in accordance with economic reality.[47]

Subsidiary Directive has recently been amended to adopt a similar approach in this area. Under the recent amendments, EU Member States are not allowed to grant the benefits of the directive to the parent company – i.e., the provision of an exemption on the intercompany dividends received – if the respective payment is tax-deductible at the level of the paying subsidiary company in the other EU Member State. The Member States are required to implement the changes to the directive into their domestic legislation as per ultimo 2015.

[44] A clear-cut example of a disparity – i.e., the juridical double taxation of cross-border dividends due to a mutual divergence between international taxing principles used – can be found in Court of Justice, case C-128/08 (*Damseaux*). See for comparison Article 293 of the former Treaty establishing the European Community (EC Treaty). Article 293 EC Treaty has been repealed under the Treaty on Functioning of the European Union.

[45] See OECD, OECD Committee on Fiscal Affairs, *Public Discussion Draft BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Recommendations for domestic laws)*, *19 March 2014 – 2 May 2014*, OECD Publishing, Paris, 19 March 2014, OECD, OECD Committee on Fiscal Affairs, *Public Discussion Draft BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Treaty Issues), 19 March 2014 – 2 May 2014*, OECD Publishing, Paris, 2014, and OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Neutralising the effects of hybrid mismatch arrangements*, OECD Publishing, Paris, 16 September 2014, OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing, 12 February 2013, OECD, *Hybrid mismatch arrangements; Tax policy and compliance issues*, OECD, Paris, 2012, and European Commission, Staff working paper, *The internal market: factual examples of double non-taxation cases, Consultation document, Brussels*, TAXUD D1 D(2012). See for some examples of tax planning arrangements under the Dutch international tax system, Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international* (2011), at section 3.

[46] *Ibidem*, and see Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 8, and Tulio Rosembuj, 'Abusive Transactions on Financial Hybrids', 39 *Intertax* 234 (2011), at 234-247.

[47] See Arthur J. Cockfield, 'The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles', 56 *Bulletin for International Taxation* 606 (2002), at 606-619, Dale Pinto, 'The Need to Reconceptualize

The inadequacies in the international tax regime may be categorized into three groups by reference to the inadequacies in the:

1. separate accounting concept, producing distortions and arbitrage in firm level decisions as regards the intra-firm legal organization of the business operations undertaken;
2. realization-based return to equity tax base standard, producing distortions in firm level decisions as regards the financing of the business operations or marginal business operations undertaken, and;
3. the methodologies used to geographically divide corporate profit, producing distortions in firm level decisions as regards the geographical location of the business operations – thereby initiating investment location distortions.

Inadequacy 1: separate entity approach

First, as said, corporate entities are typically subject to corporation tax on an individual basis under the separate entity approach. This approach is generally upheld in the event that these taxable entities belong to an integrated group.[48] However, in reality multinational groups of companies do not operate in a segregated manner. They operate in concert as a functionally integrated economic entity with a common objective of profit-optimization.

This difference in tax treatment affects the legal organization of the firm, distorting the choice of legal form.[49] The recognition of intra-firm legal transactions for tax purposes creates the possibility of arbitrage, i.e., 'profit-shifting on paper' through intra-group legal structures.[50] Separate accounting induces an incentive for multinationals to engage into the cross-border legal shifting of the firm's resources to low or no-tax jurisdictions. This occurs, as said, for instance through 'tax sheltering', i.e., the intra-group legal shifting towards these jurisdictions of financial resources or intellectual property.[51]

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the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006) at 266-280, Dale Pinto, 'Exclusive Source or Residence-Based Taxation – Is a New and Simpler World Tax Order Possible?', 61 *Bulletin for International Taxation* 277 (2007), at 277-291, Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 103-111, Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286, Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', 62 *Bulletin for International Taxation* 201 (2008), at 201-215, Michael J. Graetz, 'The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies', 54 *Tax Law Review* 261 (2001), at 261-336 and also Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 181. On transfer pricing, see Yariv Brauner, 'Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes', 28 *Virginia Tax Review* 81 (2008), see also Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 625-638.

[48] See for a comparison Wolfgang Schön, 'International Tax Coordination for a Second-Best World (Part II)', 2 *World Tax Journal* 65 (2010), at 71.

[49] See International Monetary Fund, *IMF Policy Paper; Spillovers in International Corporate Taxation*, International Monetary Fund, Washington, D.C., 2014, at 13, as well as Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010), at section 3.

[50] Cf. Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 7: *"it is well known that the SA methodology gives MNEs scope for strategic tax planning and tax avoidance, to the detriment of collection of public revenues. In particular, the current arm's length-based system for multinational groups to shift taxable profits between each Member State provides possibilities for multinational groups to shift taxable profits between the different EU countries in which they operate (i.e., by strategically manipulating the internal transfer prices of their intra-group transactions or by altering the financial structure of the group members in order to minimize the groups' overall tax liabilities) This causes tax-induced distortions to the international allocation of corporate tax bases across EU countries and is an additional reason for tax competition among national governments (further than the traditional tax competition for real investment), as identified by recent literature)."* For an overview of tax planning techniques in the area of dividend taxation, see Paulus Merks, 'Dividend Withholding Tax Planning Techniques: Part 1', 39 *Intertax* 460 (2011, No. 10), at 460-470, and Paulus Merks, 'Dividend Withholding Tax Planning Techniques: Part 2', 39 *Intertax* 526 (2011, No. 11), at 526-533.

[51] See also Richard J. Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World', 2 *World Tax Journal* 291 (2010), at 313, who refers to *"widespread evidence … that significant profits from FDI end up in tax havens of one kind or another where little real activity in fact occurs."*

Tools commonly used in this respect include setting up controlled legal entities that are recognized for tax purposes within such jurisdictions and subsequently arranging intra-group legal transactions to create tax-recognized income streams directed into those jurisdictions. This is established quite easily, as said, because of the mobile nature of these financial means or intangible resources and the absence of third-party conditions in controlled intra-firm environments in which these transactions generally take place. Textbook profit shifting arrangements involve intra-group debt financing and intellectual property licensing. These arrangements typically generate tax-deductible interest and royalty payments in countries in which investments actually take place.

Inadequacy 2: nominal return to equity tax base standard

Second, the taxable base of these corporate entities, as said, is typically defined in terms of a realization-based nominal return to equity standard.[52] A key feature of this standard is that debt and equity financing are treated differently for tax purposes. The remuneration paid for taking out debt is generally tax-deductible at the level of the debtor. The reverse is generally true for the remuneration paid for taking up equity. However, economically these types of corporate financing are essentially the same. Both provide funding in return for a remuneration, with respect to which a certain level of economic risk is incurred.

As a result debt financing us favored over equity financing for tax purposes. The different tax treatment is sometimes referred to as the 'financing discrimination' and affects financing decisions. This is particularly true for marginal investments, as financing decisions are widely known to respond to marginal effective tax rates.[53] Since interest is generally deductible while dividend is not, the current tax system provides a distortive incentive to finance marginal investment with debt as the effective tax rate on a debt-financed marginal investment is nil, while the tax rate on the same marginal investment is infinitely high if financed with equity capital.[54] Accordingly, the tax system incentivizes the financing of marginal investments with debt.

Inadequacy 3: profit division methodologies

Third, as said, the taxable profit derived by the taxable entities involved is typically assigned to tax jurisdictions on the basis of legal and physical-geographical tax jurisdiction concepts. The tax base is allocated to countries by reference to the arm's length standard.

This approach reveals its flaws in the real world. One may think of the difficulties in assigning the income from cross-border e-commerce activities. The traditional physical-geographical permanent establishment concept does not cover a virtual web store as a website cannot be considered a fixed place of business through which the taxpayer's business activities are carried on.[55] It has been argued in the literature that the international tax regime completely fails to capture the digitization of the economy as a result of that.[56]

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[52] See e.g., Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448, and Serena Fatica et al, 'Taxation Papers; The Debt-Equity Tax Bias: Consequences and Solutions', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2012:33.

[53] See Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448, and Serena Fatica et al, 'Taxation Papers; The Debt-Equity Tax Bias: Consequences and Solutions', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2012:33.

[54] See Charles E. Mclure, Jr., 'The State Corporate Income Tax: Lambs in Wolves' Clothing', in Henry J. Aaron et al, *The Economics of Taxation* (1980) 327, at 336, following Joseph E. Stiglitz, 'Taxation, Corporate Financial Policy, and the Cost of Capital', 2 *Journal of Public Economics* 1 (1973), at 1-34.

[55] See for example the efforts undertaken in this respect by the OECD, OECD Committee on Fiscal Affairs, *Clarification on the Application of the Permanent Establishment Definition in e-commerce: Changes to the Commentary on the Model Tax Convention on Article 5*, OECD, Paris, 22 December 2000.

[56] See e.g. Lee A. Sheppard, 'The Digital Economy and Permanent Establishment', 70 *Tax Notes International* 297 (22 April 2013), Charles McLure, Jr., 'Alternatives to the concept of permanent establishment', 1 *CESifo Forum* 10 (2000), at 10-16, Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006), at 266-280, and Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997). Avi-Yonah observes at 509 that the 'single tax principle is

Moreover, multinationals may be able, for example, to shift business income to low-tax jurisdictions through strategically arranging the transfer prices relating to the intra-group trading of firm specific rent-yielding assets, such as intellectual property portfolios that provide unique monopoly rights. As there are no outside markets for trading these often valuable intangible assets, it is generally impossible to find comparable transactions to determine the transfer price for these interaffiliate transactions by reference to the arm's length principle. This gives multinationals some room to reduce their overall tax burden by strategically arranging their intra-firm transfer prices.[57] In addition to this, even the OECD's 'significant people functions' concept is under some pressure in practice, for instance as a result of the increased mobility of labor.

In practice, multinationals may be able to create some modest substance in low tax jurisdictions – for example by setting up intermediate holding companies, group financing companies, intellectual property holding companies, or captive insurance companies, which companies are subsequently managed by a few people who are actually working and present within that jurisdiction. This serves the purpose of the legal allocation of substantial parts of the respective multinational's overall corporate earnings to that tax jurisdiction. The presence of some of the firm's workers in the respective low-tax jurisdiction may accordingly be used to substantiate the tax base allocation for corporate tax purposes to that jurisdiction in any discussions with the tax authorities in the high tax jurisdictions in which the firm involved is active.

Multinationals may also be able to discretionarily shift parts of their corporate profit to low-tax jurisdictions through so-called corporate conversion arrangements, commissionaires structures and principal-agent structures. In practice, multinational firms may be able to convert their fully fledged 'distributor group companies' and 'manufacturer group companies' in high tax jurisdictions – producing high profit level indicators in transfer pricing analyses – into low risk distributors and low risk manufacturers – producing low profit level indicators in transfer pricing analyses. The purpose of such conversions is to initiate a shift of the firm's economic rents to a low tax jurisdiction in which the firm's 'principal group company' is domiciled for tax purposes. The principal group company acts as the firm's 'entrepreneur' for corporate tax allocation purposes, i.e., the group company to which the risks involving the firm's business operations have been assigned legally, and on whose behalf its agents – the distributors and manufacturers – perform their low-risk, low-profit functions. The principal group company would accordingly be awarded the firm's economic rents.

This renders the international corporate tax base quite mobile since multinational firms have some discretionary power as to where to geographically locate the 'entrepreneur' for corporate tax purposes. In essence multinational firms can to setup shop in any tax jurisdictions of their choice.

The consequence: arbitrary allocation of tax among states

The consequence of these flaws in the international tax regime is that the tax burden imposed on business income depends on the question whether the economic operator performs its business activities in a cross-border context. Firms that operate in a cross-border environment have some leeway when it comes to assigning taxable corporate profit

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undermined because e-commerce makes it much easier to earn income from cross-border transactions that is not subject to tax by any jurisdiction. The benefits principle is undermined because under current rules income from e-commerce may not be taxable by the source jurisdiction'. For the recent OECD initiatives on this matter, see OECD, OECD Committee on Fiscal Affairs, *Public Discussion Draft BEPS Action 1: Address the tax challenges of the digital economy, 24 March – 14 April 2014*, OECD Publishing, Paris, 24 March 2014, and OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Addressing the tax challenges of the digital economy*, OECD Publishing, Paris, 16 September 2014.

[57] See for comparison Ruud A. de Mooij, 'Will Corporate Income Taxation Survive?', 153 *De Economist* 277 (2005), at 292, and e.g., Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 7-8.

geographically, whereas firms that operate in a single jurisdiction only do not have such leeway.

Nevertheless, we must conceptually deal with a distortion in the way in which tax is allocated between states. The following thought experiment may explain this. Suppose that all international tax systems were identical. There would be no disparities or obstacles and the tax burden on both the cross-border and domestic business activities of economic operators would be exactly the same. In the event that the current profit building blocks would be applied as presently the case, the allocation of tax between states would still fail to be in accordance with economic reality. The legal and physical-geographical oriented concepts on which the formula is built would still prove inadequate to allocate the tax between states. Just think of the digitization of the economy and the impossibility of capturing the web store under the permanent establishment concept. Still no comparable transactions could be found to establish the arm's length transfer price of the intra-firm transfer of unique intangibles within a multinational group of affiliated corporate entities. Since the concepts used in international taxation would continue to operate arbitrarily, the geographic division of corporate profit would remain arbitrary as well.

1.2 The research question: 'corporate tax 2.0?'

Should this arbitrary sharing of the tax pie under the current international tax regime be considered a problem? The answer to this question will of course depend on one's personal views on the matter. Were things to be considered from a non-critical rationalistic view, one may reply by accepting the operation of the international tax regime as the status quo: 'Things can only be considered wrong when labeled wrong on the basis of a legal statute. The law is the law. If this is how the tax law works there is no problem since legislative acts and conventions do not normatively question their own operation'. One may also answer the question with an 'I do not care', an emphatic 'no', or 'perhaps'. One may just, in the absence of a line of argument, agree have different opinions on the matter. In my view, however, one could do better.

As I see it, the arbitrage in the operation of the current international tax regime in today's emerging global market is – or at least should be – considered problematic. My answer is therefore 'yes', as I find the arbitrage problematic and unfair. I will define the term 'fairness' in the chapter 2. In my view the international tax regime operates unfairly to the extent that it enables the careful circumvention of moral obligations to contribute to society through the clever arrangement of business affairs (legally) and be rewarded with a reduced tax burden. Why should the international tax regime allow a certain class of taxpayers to escape their tax obligations while others cannot? Why should equal economic circumstances be treated differently for tax purposes? I fail to see the justification for this.

It necessarily follows from this that arguments or inferences derived from the current operation of the international tax regime – the status quo – pleading its fair operation would fall short as well. In my view, legal instruments should not be considered valid or fair by simply pointing out their existence and operation. There is no inherent moral truth in the international tax regime as it currently applies. Legal systems, including the international tax systems of nation states, are man-made intellectual achievements. They can be shaped, formed and altered to our wishes. If a rule or a legal regime is in place that does not function properly, I suggest to respond by starting to think of an alternative that does work.

So, if an international tax regime has been established that operates arbitrarily, the response should be to start thinking of an alternative that would perhaps operate better. And since the problems in the international tax regime are the product of its own operation, one would need to look for external alternatives assuming it is acknowledged that an analytical issue in corporate taxation cannot be resolved within the same tax framework that created it.[58]

[58] See for a comparison, Arnaud de Graaf, Paul de Haan and Maarten de Wilde, 'Fundamental Change in Countries' Corporate Tax Framework Needed to Properly Address BEPS', 42 *Intertax* 306 (2014), at 306-316.

This requires conventional 'tax-thinking' to be set aside to explore unconventional alternatives for the current system. It is too easy to blame the big bad multinational for seeking to optimize its tax costs by cleverly structuring its business activities to benefit from the operation of the international tax regime. Profit-optimization is an essential objective of a multinational firm. It should not be forgotten that the nation states are the ones who designed the international tax regime. If they fail to properly tax multinationals, they should design something better. Indeed, *"[t]he charge to tax must fairly fall within the words of the law and, if it cannot, then that is a question for the legislature"*[59] Fairness in corporate taxation is not a corporate responsibility; it is the responsibility of the nation states.

This perhaps explains why the various commentators explore unconventional alternative means to share the international corporate tax pie; the corporate tax 2.0.[60] And this may also explain the approaches taken within the European Union's project to establish a Common Consolidated Corporate Tax Base – the CCCTB.[61] The Commission's proposal of 16 March 2011 for a coordinated European Union-wide corporate tax essentially seeks to provide a comprehensive solution for the inequities and inefficiencies in the application of the twenty-eight different corporate tax systems in the European Union. [62-63] Insofar as the division of the tax pie within the European Union is concerned, the CCCTB proposal, for instance, does away with the concept of separate accounting, differences in the definition of the tax base, and the arm's length standard and replaces these by a harmonized tax base that is shared between the European Union Member States on the basis of a predetermined fixed formula and which tax base is subject to a European Union-wide corporation tax that is effectively levied from tax consolidated groups.

This study seeks to do the same; an autonomous exploration of some alternative ways to share the international pie. This study therefore necessarily questions all the building blocks of the current international tax regime.

Accordingly this study takes a 'clean-slate-approach'. It is based on a single axiom only, namely the principle of equality. The concept of tax parity of economic equal circumstances underlying the concept of tax fairness as I understand it is the postulate that is the departure point of the reasoning in this study.[64] The approach taken may be considered unconventional. Indeed, *"[i]n fact, our whole tax system develops relatively conservatively. There is a strong preference to change by interpretation, through 'massaging' of rules and concepts, and almost a religious belief that old concepts must be good for new realities if we just stretched them in the right way.*[65] And indeed, as Brauner notes *"[t]his reality resulted in an inefficient system."*[66]

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[59] See Peter Harris, 'The CCCTB GAAR: A Toothless Tiger or Russian Roulette?', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012), at 294.
[60] See for some proposals Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), and Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08.
[61] Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). For some reading and analysis, see Hueyla Celebi, 'The CCCTB as a Proposed Solution to the Corporate Income Taxation Dilemma within the EU', 22 *EC Tax Review* 289 (2013), at 289-298.
[62] European Commission, 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*, COM(2001) 582 final, Brussels, 23 October 2001. Here the Commission established its policy for developing the CCCTB. It confirmed it in its Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, *An Internal Market without company tax obstacles achievements, ongoing initiatives and remaining challenges*, COM(2003)726 final, 24 November 2003.
[63] Kindly note that Croatia has joined the European Union per 1 July 2013.
[64] That is as I cannot argue *why* I consider that equal circumstances should be treated equally. See for some comparison the observation of Traub that 'the economic view of man is based on the assumption of rationality derived from a system of normative principles'. See Stefan Traub, 'Equitable Taxation: Qualitative versus Quantitative Ratings', 9 *Journal of Economics* 223 (2002), at 223-240.
[65] See Yariv Brauner, 'Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes', 28 *Virginia Tax Review* 81 (2008), at 93.
[66] *Ibidem*, at 94.

This paves the way to put forward the *research question* that this study seeks to address:

How should business proceeds of multinationals be taxed?

How should we tax multinationals in a global market? How should we share the pie? Is it possible to think of something better than the current model? What would such an alternative model look like? How would such a corporation tax 2.0 operate?

1.3 The approach taken to finding an answer

1.3.1 Seeking a normative framework

This question cannot be answered as easily as it is posed. The following remarks may therefore be worth making. I seek to answer the central questions by means of a qualitative analysis. The line of reasoning is essentially built on three steps which are addressed by reference to the following three sub-questions. The answer to these questions enables the lining-up of the building blocks of a corporation tax 2.0 in the final chapter, chapter seven:

1. How should the notion of 'fairness' in corporate taxation be understood?
2. How should the obstacles be removed?
3. How should the disparities and adequacies be remedied?

Before giving an overview of the outlines of the following chapters, it should be mentioned that the objective of this study is to tentatively forward suggestions for an ideal model to tax multinationals in a global market environment. It seeks the 'ought' rather than the 'is'. The aim is to consistently put forward the real argument, rather than the argument of authority.

All observations, arguments and conclusions in this study are the outcome of autonomous reasoning. The study does not resort to the existing domestic tax systems or the double tax convention networks in the current international tax regime as a normative benchmark. It does not adhere to or resort to authorities legal or otherwise as a stepping-stone for building the analysis.

Indeed, various references are made to tax concepts and approaches in a variety of countries, tax conventions and model tax conventions, legislative acts, court rulings and doctrine. References are also made to the existing international principles of source, residence and nationality, as well as the existing economic policy concepts of capital and labor import neutrality and capital and labor export neutrality. But rather than to provide normative points of departure, all references to, borrowings from and analogous interpretations of the materials in the current tax model are included for the sake of convenience, or for explanatorily or illustrative purposes or otherwise worth addressing in support of the underlying theoretical analysis.

The sole axiom appreciated in this study is the notion that equal economic circumstances should be treated equally for tax purposes. This study is the product of a deduction from the principle of equality as I understand it. To substantiate my reasoning I have sought to carefully and logically build the analysis. Where convenient, considered appropriate or for illustrative purposes, reference is made to the available legal materials, as well as studies and analyses in both law and economics. Where considered illustrative or necessary, numerical and formulaic examples have been developed autonomously or by analogue. Some occasional references are made to my personal observations as a practicing tax lawyer.

This paper presents a qualitative analysis. No empirical research has been undertaken. I am a tax lawyer, and neither a trained economist nor a behavioral scientist. I am also not a statistical analyst. This study therefore does not provide in-depth empirical impact assessments explaining current economic or behavioral effects of the international tax regime

or forecasting future effects of any changes thereof. Any available literature will respectfully be referred to for that matter.[67] Moreover, as no data exists on the effects of the theoretical system developed in this study, obviously no quantitative research thereof has been performed either. This paper, accordingly, is the outcome of a normative research, which integrates qualitative legal, philosophical, and economic analysis in an interdisciplinary manner, referring to empirical studies as an auxiliary.

Furthermore, the study does not address the various practical hazards and issues of a potential implementation of any of the suggestions made. No consideration has been given to problems with drafting relevant legal texts or coping with transitional problems, nor to any political realities perhaps pointing in a different direction. Should the findings of this study ever be or considered to be implemented in the real world, to say the least one should consider the considerable practical hazards thereof. Just think of incorporating the concepts into legal texts, the transitional issues involved in their adoption, and the political views, willingness and consensus required to merely consider the adoption of the suggestions put forward in the following chapters. One may be prone to conclude that such a project is hopeless and throw in the towel, perhaps even beforehand.

In sum, it is not my aim to provide a clear-cut, ready-to-use alternative international tax model, including draft legal texts in annexes, analyses on transitional issues and assessments of future behavioral effects. I merely seek to discover, through logic reasoning, some of the missing pieces of the current international tax jigsaw puzzle. In other words, to come up with an alternative framework of reference, a model of thought the purpose of which perhaps is to provide an analysis for future thinking and discussion. In the end my aim is to simply come up with some alternative ideas on the issue of how multinationals should be taxed in a global economic environment.

1.3.2 Part II: Chapter 2 – Some thoughts on fairness in corporate taxation

In Chapter 2 the first sub question, the question of how to understand the concept of 'fairness' in corporate taxation as I understand and interpret it is addressed. I have drawn inspiration from international tax theories and the objectives underlying the current legal framework of

[67] For economic analyses on the responsiveness of real economic activity to tax rate differentials see, e.g., Clemens Fuest, Christoph Spengel, Katharina Finke, Jost H. Heckemeyer, and Hannah Nusse, 'Profit Shifting and "Aggressive" Tax Planning by Multinational Firms: Issues and Options for Reform', 5 World Tax Journal 307 (2013, No. 3), at 307-324, Michael P. Devereux et al, 'Taxing Multinationals', *National Bureau of Economic Research Working Paper* 2000:7920, European Commission, 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*, COM(2001) 582 final, Brussels, 23 October 2001, Ruud de Mooij et al, 'Taxation and Foreign Direct Investment: A Synthesis of Empirical Research',10 *International Tax and Public Finance* 673 (2003), at 277-301, Ruud de Mooij, 'Will corporate income taxation survive?', 3 *De Economist* 153 (2005), at 277-301, Harry Huizinga et al, 'International profit shifting within multinationals: a multi-country perspective', *European Commission, Directorate-General for Economic and Financial Affairs Economic Paper* 2006:260, Michael P. Devereux, 'Taxes in the EU New Member States and the Location of Capital and Profit', *Oxford University Centre for Business Taxation Working Paper* 2007:0703, Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 710-711, Michael P. Devereux, 'Business taxation in a globalized World', 24 *Oxford Review of Economic Policy* 625, (2008), at 625-638, Michael P. Devereux et al, 'Do countries compete over corporate tax rates?', 92 *Journal of Public Economics* 1210 (2008), at 1210-1235, Johannes Voget, 'Headquarter Relocations and International Taxation', *Oxford University Centre for Business Taxation working paper* 10/08, Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), at 17-18, and Ruud A. de Mooij et al, 'An applied analysis of ACE and CBIT reforms in the EU', 18 *International Tax and Public Finance* 93 (2011), at section 3.3, European Commission, Staff Working Document, *Impact Assessment, Accompanying document to the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, SEC(2011) 315 final, 16 March 2011, Christoph Spengel et al, 'A Common Corporate Tax Base for Europe: An Impact Assessment of the Draft Council Directive on a CC(C)TB', 4 *World Tax Journal* 185 (2012), at 185-221, and Leon Bettendorf et al, *The economic effects of EU-reforms in corporate income tax systems,* Study for the European Commission, Directorate General for Taxation and Customs Union, Contract No.TAXUD/2007/DE/324, October 2009. See further Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 7 and OECD, *Addressing Base Erosion and Profit Shifting,* OECD Publishing, 12 February 2013, at Chapter 2 – also for literature references.

the European Union. The chapter addresses the parameters of my notions of fairness in taxation as I boiled these down from my interpretation of the maxims of equity and economic efficiency as developed in international tax theory.[68]

My basic argument is that fairness in corporate taxation is founded on the equality principle, conforming to the historically widely acknowledged notion of equal treatment before the law. Economic equal circumstances *in se* should be treated equally for tax purposes and unequal economic circumstances *in se* should be treated unequally insofar as circumstances are unequal.

The normative requirement of tax parity in equal economic circumstances, should in my view be kept separate from the application of the relevant tax laws in a particular case as the tax effects in a certain case are tested against the benchmark of the notion of tax parity in equal circumstances – from which taxation is excluded as the subject of the analysis. The tax effects in a particular scenario should be separated analytically from the fairness concept as these tax effects constitute the 'test object' against which the equality principle is tested. This allows a normative analysis of the tax effects without the tax effects influencing the outcome of the test; much like the results of a numerical calculation do not affect the underlying mathematical rules directing those results.

It can be deduced from the equality postulate that everyone in an economic relationship with a taxing state has the obligation to contribute to the financing of public goods from which one benefits in accordance with one's means – 'equity'.[69] Production factors should be distributed on the basis of market mechanisms, without public interference or at least with as little public interference as possible – 'economic efficiency'. Taxation should follow economic reality, rather than steering it. Taxation should, neither positively, nor negatively affect business decisions – i.e. tax neutrality, including the concept of neutrality of the legal form.

These starting points then serve as the basis of a framework that is built in the following chapters addressing both the 1920s Compromise and the model I seek to develop in this study. An overview of the building blocks for this model is given in Chapter 7. Pivotal concepts include the concepts of 'internal equity' and 'internal production factor neutrality' autonomously developed in Chapter 3, the 'theory of the firm' derived from Coase in Chapter 4, the 'Schanz-Haig-Simons concept of income'[70] in Chapter 5 and the quest for the location of the 'true' geographical source income based on a spectrum that includes the notions of origin and destination in Chapter 6.

1.3.3 Part III: Chapter 3 – Towards a fair international tax regime; eliminating obstacles

Chapter 3 addresses the second sub question, i.e., the question of how the obstacles in the current international tax systems of states should be eliminated. As said, countries currently

[68] See for a comparison Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Parts I, II & III)', 8/9 *Intertax* 216 (1988), at 216-228, 10 *Intertax* 310 (1988), at 310-320 and 11 *Intertax* 393 (1988), at 393-402, Nancy Kaufman, 'Fairness and the Taxation of International Income', 29 *Law and Policy in International Business* 145 (1998), at 145-203 and Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapter 1.

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

[70] See Georg Schanz, 'Der Einkommensbegriff und die Einkommensteuergesetze', 13 *Finanzarchiv* 1 (1896), at 1-87, Robert M. Haig, 'The Concept of Income: economic and legal aspects', in Robert M. Haig (ed.), *The Federal Income Tax* (1921), Henry C. Simons, *Personal Income Taxation* (1938). For extensive analyses on the S-H-S concept of income, see Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapter 2. It is noted that countries typically do not implement the theoretical S-H-S concept of income to its full extent in practice. For example, most states do not tax capital gains on an accrual basis, but postpone corporate taxation up until the moment that the capital gain has been realized (the realization principle). However, most states also allow for tax deductible impairments on commercially devalued assets, which have not yet been realized (the principle of due care). The question on whether the S-H-S concept of income is adequately implemented in the international tax systems of states is addressed in Chapter 5. See also OECD Tax Policy Studies, *Fundamental Reform of Corporate Income Tax*, No. 16, OECD, Paris, 2007.

autonomously decide on the definition of a taxable entity and that of the taxable base, the tax rate to be applied, as well as the international tax principle employed to establish tax jurisdiction.

The chapter conceptually builds on the assumption that fiscal sovereignty in corporate taxation rests with the nation state – i.e., as is currently the case. The presence of disparities or mismatches in the international tax regime is necessarily assumed. Given the fact of non-coordination, the question arises as to how to achieve tax fairness within an international tax system of a state. What could or should nation states unilaterally do to eliminate the obstacles they unilaterally impose?

Inspired by a melting pot of what I consider the best elements in existing theories, concepts and practices in international tax law, I put forward the argument that a nation state's international tax system should be internally fair. This results in a concept that is referred to as 'internal equity' and 'internal production factor neutrality'.

For this purpose, the equality principle is explored similarly to the fundamental freedoms as applicable within the European Union and the interpretation of the principle of equality by the Court of Justice. The operation of European Union law in this area is considered to be of more help than the operation of the non-discrimination rules in the double tax conventions and human rights conventions currently in place. The non-discrimination rules in double tax conventions merely provide a bundle of non-discrimination rules to be appreciated by the source state, rather than a non-discrimination principle underlying the international tax system of the relevant country.[71] The non-discrimination concepts in human rights conventions provide the countries involved wide margins of appreciation to differentiate in the tax treatment of residents and non-residents and the tax treatment of domestic and foreign investment. So these are considered not all too helpful in this area either. On the contrary, the fundamental freedoms in European Union law provide for an equality principle devoid of statutory limitations and appreciation margins. In my view, the freedoms provide the analytically soundest approach towards parity in tax treatment. The fundamental freedoms have the potential to drive our rethinking of the design of the international tax regime towards a full appreciation of the equality principle in corporate taxation.

Moreover, the widely known tax policy concepts of capital and labor import neutrality and capital and labor export neutrality are scrutinized to demonstrate that tax neutrality is actually absent in these two concepts. Import neutrality promoting tax systems distort production factor exports; export neutrality promoting tax systems distort production factor imports. The same necessarily goes for double tax relief systems in any international tax systems that are based on these neutrality concepts. An alternative concept is developed that is referred to as 'production factor neutrality'. This neutrality concept holds water as it proves to promote tax neutrality in both inbound and outbound movements of the production factors capital, labor and enterprise. To my knowledge, this interpretation of the tax neutrality concept is original.

The point is made that 'internal equity' and 'internal production factor neutrality' require the taxation of the worldwide business proceeds of firms that have nexus in a taxing state. To acknowledge the single tax principle this worldwide taxation should be combined with an equitable and neutral form of double tax relief. For that purpose, I adhere to the mechanism currently applied in the Netherlands' international tax system: the 'credit for domestic tax attributable to foreign income'. This produces an approach where all countries involved tax the fraction of the worldwide income to which they are entitled: 'taxing the fraction.'

Chapter 3 concludes by illustrating the non-distortive effects of the advocated fractional approach through numerical examples dealing with progressive tax rates, cross-border

[71] Cf. Mary C. Bennett, 'The David R. Tillinghast Lecture; Nondiscrimination in International Tax Law: A Concept in Search of a Principle', 59 *Tax Law Review* 439 (2005 - 2006), at 439-486. Bennett argues that Article 24 of the OECD Model Tax Convention provides for an incoherent set of rules, which unlike European Union law lack an overarching rationale. On the relationship between Article 24 and the equality principle under primary EU law, see Niels Bammens, 'The Interaction between the Interpretation of Article 24 OECD MC and the Non-discrimination Standard Developed by the CJEU', 22 *EC Tax Review* 172 (2013), at 172-186.

losses, intra-firm modes of transfers and currency exchange rate movements. For this purpose I invite the reader to engage in a thought experiment applying identical international tax systems at both sides of the tax border and to analytically cancel out the effects of any disparities. The approach taken corresponds conceptually to the 'internal consistency test' in US constitutional law.[72]

1.3.4 Part IV: Chapters 4 through 6 – Towards a fair international tax regime; eliminating disparities adequately

1.3.4.1 General remarks

Chapters 4, 5 and 6 are devoted to formulating some answers to the question of how to adequately remedy any disparities in the international tax regime. These chapters basically build on the observation that the disparities or mismatches in the international tax regime can be removed through coordination. The distortions in the operation of the global market caused by the mutual divergences between the international tax systems of sovereign states may be resolved by coordinating the tax entity definitions, the tax base definitions and the tax base allocation methodologies. Basically the point is made is that coordinated international tax systems, by definition, are not disparate international tax systems.

Chapters 4 through 6 build on the assumption that nation states may be willing to let go some of their sovereign rights in the area of direct taxation or are at least willing to coordinate their tax entities, tax bases and tax allocation methodologies to some extent.

This should by no means be unattainable. The current international tax regime has characteristics that basically all corporate tax systems worldwide have in common; so some tax coordination already exists, but the building blocks of the international tax system operate inadequately. Moreover, the ideas for the coordination of the current model and the development an alternative model are not that new. Illustrative is the work that has been undertaken within the European Union that currently seeks to adopt a harmonized corporate tax system for European businesses.

In the end, tax coordination is a matter of political willingness – nothing more and nothing less – and should be accordingly recognized for what it is.[73] Indeed, *"the case … turns largely on the question of whether our tax rules should follow the centripetal forces of an increasingly global economy or the centrifugal forces of politically sovereign states."*[74] Hellerstein notes: *"My sense is that the former will ultimately prevail over the latter…"*[75]

Let's assume that there is a political will to arrive at some sort of coordinated tax system. This begs the question of how to design such a coordinated international tax regime. What would be a fair alternative for the current system? How should be the design of the tax entity for instance? How should the tax base be defined and geographically be divided among countries?

If one were to coordinate and change the international tax regime coherently, why not change things for the better, change the scenery and look for approaches that may actually bring

[72] See e.g., United States Supreme Court, *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983), and *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995). See for some analysis Ruth Mason, 'Made in America for European Tax: The Internal Consistency Test', 49 *Boston College Law Review* 1277 (2008), at 1283, and Walter Hellerstein, 'Is Internal Consistency Dead?: Reflections on an Evolving Commerce Clause Restraint on State Taxation', 61 *Tax Law Review* 1 (2007-2008), at 1. See also the prequel to this article, Walter Hellerstein, 'Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation', 87 *Michigan Law Review* 139 (1988-1989).

[73] This phrase draws freely on Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', *2 World Tax Journal* 3 (2010), at 15, observing that *"political opposition should be recognized for what it is."*

[74] See Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 111.

[75] *Ibidem*.

about fairness in the taxation of multinational firms? For this purpose, the following three questions are addressed in chapters 4, 5 and 6 below:

1. Who should be taxed?
2. What should be taxed?
3. Where should it be taxed?

The question of whether tax rates should be coordinated or how to appreciate tax rate disparities and subsequent fiscal competences is not addressed in a separate chapter. Instead, the issue of rate coordination or revenue sharing is touched upon in the final section of Chapter 6.

1.3.4.2 Chapter 4 – The group as a taxable entity

Chapter 4 is devoted to finding an answer to the question of who to tax. What should be considered the appropriate taxable entity or 'tax subject'? As income tax applies to natural or legal persons – the income tax as a personal, or *ad personam* tax – the question of whom should be considered the taxpayer must be answered. Who earned the income?

Inspired by Coase's 'theory of the firm',[76] or 'internalization theory', I will argue that the integrated firm should be treated as a single entity for tax purposes rather than its constituent individual corporate bodies. The international tax regime should let go of the separate entity approach, i.e., the classical system of corporate taxation in which each (affiliated) corporate body forms a separate taxable entity, and permanent establishments are seen as distinct and separate enterprises for tax base allocation purposes. The separate entity approach needs to be abandoned and replaced by a 'unitary business approach'. The multinational should be treated as a single tax entity for corporate tax purposes. This may technically be achieved through a mandatory tax consolidation for instance. This would enable the economic entity, i.e., the multinational firm, to be treated as the taxable entity.

From there on I build a framework to identify the taxable entity as the first building block for the conclusions in Chapter 7. The economic entity should be treated as the taxable entity. For the purpose of defining the group for corporate tax purposes, I argue that tax consolidation should be mandatory for: (a) corporate interests that give the ultimate parent company a decisive influence over the underlying business affairs of its subsidiaries, provided that (b) the parent company holds its corporate interest as a capital asset. In addition, tax consolidation should be mandatory in both domestic and cross-border scenarios ('worldwide tax consolidation').

Following on from the building blocks for an internally equitable and capital-and labor neutral international tax system developed in Chapter 3, it is argued that the group should be subject to an unlimited corporate tax liability, that is taxation of the worldwide income in each taxing jurisdiction in which it exceeds a minimum threshold of economic activity. In cross-border scenarios, double tax relief should subsequently be given on the basis of the Dutch-style methodology referred to as the credit for domestic tax attributable to foreign income.

[76] Originally stated by Coase in Ronald H. Coase, 'The Nature of the Firm', 4 *Economica* 386 (1937), at 386-405. See also Jean-Francois M. A. Hennart, 'Theories of the Multinational Enterprise', in Alan M. Rugman (ed.), *Oxford Handbook of International Business* (2009), at 125-145, Richard J. Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World', 2 *World Tax Journal* 291 (2010), at 293-294, Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 826. See also Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286, Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', 62 *Bulletin for International Taxation* 201 (2008), at 201-215, and Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 103-111.

1.3.4.3 Chapter 5 – Economic rents as taxable base

Chapter 5 is devoted to finding the appropriate tax base or the 'tax object'. An income tax not only applies to persons – i.e., as an *ad personam* tax; it may also be considered an *in rem* tax that applies to the taxable object, being the 'income derived'. This triggers the question of what should constitute the taxable base. What should be taxed?

The analysis is inspired by the 'Schanz-Haig-Simons' concept of income or the 'capital accrual theory' and builds on the widely acknowledged notion that multinational firms derive rents. The argument is made that the international tax regime should autonomously identify a taxable base for corporate tax purposes by reference to a firm's economic rents. Economic rents constitute the remuneration in return for the provision of the production factor of enterprise.

The approach taken is to arrive at a tax system under which basically only the above-normal returns are taken into account for the purposes of calculating the corporate tax base. Various commentators advocate the approach of taxing rents instead of profits. Such an approach could technically be achieved by means of an allowance for corporate equity or via a cash flow tax. The allowance for corporate equity ('ACE') provides a deduction for equity, equivalent to interest.

It is argued that fairness requires nation states to make use of a tax base foundation concept containing an allowance for corporate equity. That is to appropriately mitigate the financing discrimination issues that arise under a typical nominal return to equity based tax system. An allowance for corporate equity produces c.q. promotes an equal to statutory average effective tax rate, a nil marginal effective tax rate, and mitigates the distortions that arise under a common corporate tax in the presence of differentials in tax depreciation and economic depreciation. The present values of depreciation and allowances for corporate equity are independent of the rate against which assets are written-off in the tax bookkeeping.

Moreover, in respect of minority shareholding investment proceeds it is argued that economic double taxation effects should be mitigated by means of a relief mechanism that will be referred to as the 'indirect tax exemption'. Such a mechanism would basically operate as an indirect credit, with the exception that the credit available is calculated by reference to an amount equal to the domestic tax that can be attributed to the excess earnings of the respective entity in which the equity investment is held. To efficiently arrive at a single taxation of the business cash flows involved, the economic double tax relief mechanism would be combined with a 'loss recapture mechanism' and a 'profit carry forward mechanism'. The neutral operation of such a double tax relief system is demonstrated by means of numerical and formulaic examples. To my knowledge, the relief mechanism developed in this study is original.

1.3.4.4 Chapter 6 – In search of an allocation mechanism

Chapter 6 seeks to answer the question as to how the corporate tax should be geographically divided among the tax jurisdictions, 'Where should we impose tax?' How should the global firm's taxable base be allocated geographically? The chapter is devoted to the development of a proper allocation key as an alternative to the current distortive profit attribution methodologies in international taxation. A daunting task indeed. Yet, it seems a necessary one in a global market where sovereign nation states all want a slice of the pie.

The analysis is inspired on the theory of the firm and the notion that the firm's business proceeds should be taxed only once as close as possible to its source. This implies the need to engage into a search of available approaches to pinpoint the geographic locations where the firm adds economic value. This however begs an answer to the question as to how the true geographic source of economic rents derived by a global firm should be determined.

The observation is made that income lacks geographic attributes. Income has no geographic location. Income production as the resultant of the interplay of inputs and outputs of a firm are as global as is the multinational itself. This may render it somewhat pointless to search for the

true source of income. This however does not mean that there is nothing to be said about the matter.

The chapter reviews the spectrum of possible angles ranging from the firms' inputs locations at origin to the firms' outputs locations at destination. The argument is made that if one only needs to agree on the allocation key, perhaps the most sensible thing to do is to aim at taking away arbitrage opportunities as much as possible. That would lead to an attribution of tax base by reference to elements that seem rational to use but are not within the firm's control. The tax allocation would operate invariantly to the location of resources in such a case.

The argument is made that it would be sensible to attribute tax base by adhering to the demand side of income production. That is because income may be seen as the resultant of the interplay of both supply and demand with the supply side being under the control of the firm involved whereas the firm has no, or at least little, control over the demand. That would produce a destination based tax base attribution approach where the tax base is assigned to the market jurisdiction, rather than the production jurisdiction, as is currently the case in international taxation.

It is further argued that such a destination based tax base attribution approach would enhance fairness. It would promote a global efficient and non-discriminatory allocation of firm inputs. The system would cease to distort investment location decisions for tax reasons, even in the event of movements in currency exchange rates and interest rates. To my knowledge this property of the advocated system is original. The allocation of firm rents to the market jurisdiction would significantly mitigate the incentives to shift taxable profit by shifting corporate investment across tax borders, which exist under the current origin oriented international tax regime.

The ideal would be to adopt a destination based tax base attribution approach on a worldwide coordinated basis. But even if it would be impossible to achieve international consensus at this point, a strong incentive would exist for individual states to move towards assigning the tax base to the market state. That is because that would very likely boost domestic competitiveness, attracting foreign direct investment and employment, and driving economic growth as a consequence. If one country would decide to implement a destination based corporate tax system – particularly if it would involve a major production country – chances are that others would follow suit. It would be in their self-interest. The adoption of a destination based tax base attribution by that first nation state may initiate a knock-on effect with an end-result of a worldwide adoption by nation states of destination based corporation tax systems.

A transformation of the current origin based system into a destination based fractional corporation tax system would perhaps entail a redistribution of tax revenues across countries. The distributional effects would be hard if not impossible to predict, though. Matters would depend on various future behavioral effects. Both from the perspectives of the multinationals and the tax jurisdictions involved. The question is which countries would gain and which countries would lose out seems dependent on domestic corporate sales to corporate income ratios, ceteris paribus.

1.3.5 Part V: Chapter 7 – Sharing the pie; building blocks for a 'corporate tax 2.0'

The final Chapter 7 contains the conclusions of this study. It is argued that the building blocks of a fair corporate tax 2.0 can be summarized as follows:

- Fairness in corporate taxation calls for tax parity in equal economic circumstances;
- Taxing the fraction; corporate taxpayers would be subject to worldwide taxation in each jurisdiction in which it has nexus – double tax relief would be granted by reference to the domestic tax attributable to the taxpayer's nexus abroad;
- The firm involved would constitute the tax entity;
- The firm's rents would constitute the taxable base;

- The firm's rents would be geographically assigned by reference to the firm's sales at destination.

1.3.6 Drawing from and building on my earlier publications

Before proceeding, it is noted that parts of Chapters 1 through 4 and 6 have been drawn from and build on the following of my publications – see also footnotes 1, 77, 172, 548 and 1218:

- Maarten F. de Wilde, *Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy*, 38 Intertax 281 (2010);
- Maarten F. de Wilde, *A Step towards a Fair Corporate Taxation of Groups in the Emerging Global Market,* 39 Intertax 62 (2011);
- 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,
- 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;
- 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, and;
- Maarten F. de Wilde, *Tax competition within the European Union – Is the CCCTB-directive a solution?*, 7 *Erasmus Law Review* 24 (2014), at 24-38.

Section 3.2.4 of Chapter 3 has been drawn from Maarten F. de Wilde and Ciska Wisman, *The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market*, 22 EC Tax Review 44 (2013, No. 1). The paragraph in section 4.2.3 of Chapter 4 under the header '*Some certainty as to the applicable freedom in third-country scenarios since FII 2*' has been drawn from Erwin Nijkeuter and Maarten F. de Wilde, *FII 2 and the Applicable Freedoms of Movement in Third Country Situations*, 22 EC Tax Review 250 (2013, No. 5) – see also footnotes 270, and 663, respectively.

Part II – Some thoughts on fairness in corporate taxation

– Chapter 2 –

Some thoughts on fairness in corporate taxation

Chapter 2 Some thoughts on fairness in corporate taxation

2.1 Introduction[77]

This first chapter, which also makes up the first constituent part of the analysis in this study, addresses the first sub question, i.e., the question as to how the concept of 'fairness' in international corporate taxation should be understood. What should be the benchmark to assess the fairness or unfairness of the international tax regime? What constitute the principles for a sound tax system?

This chapter describes the concept of 'fairness' as I understand and interpret it. Inspired by a combination of international tax theory and the objectives that underlie the legal framework of the European Union, I address the parameters of my notions on fairness in taxation. These parameters will be based on my interpretation of the maxims of equity and economic efficiency as developed in international tax theory.[78]

The basic argument made is that the notion of fairness in corporate taxation is founded on the equality principle, conforming to the historically widely acknowledged notion of equal treatment before the law. Economic equal circumstances *in se* should be treated equally for tax purposes and unequal economic circumstances *in se* should be treated unequally insofar as circumstances are unequal.

The normative requirement of tax parity in equal economic circumstances, in my view, should be kept separate from the application of the respective tax laws in a particular case as the tax effects in the case at hand are tested against the benchmark of the notion of tax parity in equal circumstances from which taxation is excluded as the subject of analysis. The tax effects in a particular scenario should be separated analytically from the fairness concept as these tax effects constitute the 'test object' against which the equality principle is tested. This allows a normative assessment of the tax effects without the tax effects influencing the outcome of the test; in the same way that the results of a numerical calculation do not affect the underlying mathematical rules that direct the outcome.

It can be deduced from the equality postulate that everyone in an economic relationship with a taxing state has the obligation to contribute to the financing of public goods from which one benefits in accordance with one's means – 'equity'.[79] Production factors should be distributed on the basis of market mechanisms, without public interference or at least with as little public interference as possible, i.e. 'economic efficiency'. Taxation should follow economic reality, rather than steering it. Taxation should, neither positively, nor negatively affect business decisions – i.e. tax neutrality, including the concept of neutrality of the legal form.

The argument is made that equity and neutrality may ultimately only be achieved through a worldwide harmonization of tax laws. That would require a transfer of sovereignty to a supranational body. Perhaps this is an unrealistic scenario politically, as states seem to be unwilling to give up their sovereign powers in the field of direct taxation. Perhaps, the tax sovereignty of states should therefore be seen as a given, at least when it comes down to setting the tax rate.

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[77] This chapter draws from and further builds on Maarten F. de Wilde, 'Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy', 38 *Intertax* 281 (2010).

[78] See for a comparison Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Parts I, II & III)', 8/9 *Intertax* 216 (1988), at 216-228, 10 *Intertax* 310 (1988), at 310-320 and 11 *Intertax* 393 (1988), at 393-402, Nancy Kaufman, 'Fairness and the Taxation of International Income', 29 *Law and Policy in International Business* 145 (1998), at 145-203 and Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapter 1.

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

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

2.2.1 The allocation of corporate tax should be equitable and economically efficient

2.2.1.1 Also a corporate tax should be fair

Fairness requirement in corporate taxation cannot be simply denied

International tax theory basically widely adheres to the notion that the allocation of the tax burden among taxpayers and the tax revenue between nation states should be equitable and economically efficient.[80] These normative cornerstones of a fair tax system were already rudimentarily acknowledged in the 18th century by Adam Smith as the 'maxims of equity'.[81]

Notions on fairness as developed in international tax theory traditionally constitute the normative foundation with respect to the allocation of individual income tax.[82] This should also be the case when the discussion involves an assessment of the fairness in international corporate taxation. Why should a corporate tax escape the normative requirement of being fair? Corporate taxation should be imposed in a fair way.[83]

Perhaps this view is considered controversial. A cynic may very well deny the fairness requirement in corporate taxation altogether. He may argue that a corporate entity does not need to be treated fairly as a corporate entity does not even exist in reality – the 'artificial entity theory'. A legal entity is merely a legal construct, a stamped piece of paper. And perhaps a piece of paper should not be taxed in the first place. And even if such a legal construct should be taxed, there is no reason to treat a construct equitably and economically efficiently for tax purposes – the cynic might add.

Corporate tax is a pre-individual tax; if individuals should treated fairly for tax purposes, by inference, so should corporations

I respectfully disagree with this position. Indeed, the legal entities that are subject to corporate tax are merely persons by virtue of the company laws under which they have been created. Corporate legal entities are persons by law, having legal personality, which allows them to operate a business legally and to derive a profit from it. Corporate entities can therefore, legally, also be taxed. And indeed, as a corporate entity is just a legal construct in the end, the underlying individuals are the persons who ultimately effectively bear the tax imposed on the corporate entity. This does not mean, however, that it does not matter whether corporate entities are treated fairly or unfairly for tax purposes.

The first answer given to the cynic might be that a corporate tax conceptually operates as an 'advance levy' to the income and consumption taxes imposed on the individuals behind the entity – the 'aggregate theory'.[84] And as the tax treatment of individuals should be fair, corporations should also receive a fair tax treatment as the corporation tax charged to a corporate body can be seen as a (temporary) replacement of the individual income tax

[80] See for a comparison Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Parts I, II & III)', 8/9 *Intertax* 216 (1988), at 216-228, 10 *Intertax* 310 (1988), at 310-320 and 11 *Intertax* 393 (1988), at 393-402, Nancy Kaufman, 'Fairness and the Taxation of International Income', 29 *Law and Policy in International Business* 145 (1998), at 145-203 and Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapter 1. For an overview of the history of tax, reference is made to Ferdinand H.M. Grapperhaus, *Tax Tales from the Second Millennium; Taxation in Europe (1000 to 2000), the United States of America (1756 to 1801) and India (1526 to 1709)* (2009), and Ferdinand H.M. Grapperhaus, *Taxes Through the Ages: A Pictorial History* (2009).

[81] See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1796), at 255-259.

[82] See Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 827.

[83] A plea not to repeal corporate taxation can be found in Reuven S. Avi-Yonah, 'Corporations, Society and the State: A Defense of the Corporate Tax', 90 *Virginia Law Review* 1193 (2004), at 1193-1255.

[84] See Michael J. Graetz, 'The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies', 54 *Tax Law Review* 261 (2001), at 301-306.

chargeable to the individuals behind the corporate body.[85] So, if the individual ultimately effectively pays the corporation tax, it seems sensible to argue that corporation tax should be levied equitably and neutrally since the individuals behind the entity who effectively pay the tax should receive a fair tax treatment.

At the end of the day the reality is that indeed only individuals pay tax. All taxes are ultimately borne by individuals rather than legal constructs.[86] Although we do not know exactly who bears the tax as the incidence of corporation tax is unknown, this still holds true.[87] The corporation tax may be effectively borne by the firm's owners, i.e., the statutory incidence of a corporation tax. But the owner does not necessarily have to bear the tax in the real world. The tax burden may also be passed on to the firm's customer, the consumer, or passed back to a worker of the firm or its supplier. In the end it comes down to the relative elasticities in supply and demand in the relevant markets involving the production factors used and the products sold to make a profit. The tax incidence depends on the given price elasticities in the labor markets, the capital markets and the customer markets at a given time and place. In reality, as said, the tax incidence is unknown.

Multinational firms exist as economic entities

This being said, it is not implied, however, that corporate taxation should be abolished as it is allegedly sufficient to tax the underlying shareholders, the individuals.

As a second response to the cynic could be that multinational firms may be considered to exist in the real world as economic entities separate from their owners – the 'real entity theory'.[88] That would provide a first argument to tax the firm separate from its shareholders. Firms may be considered real as they are homogenous units created economically to maximize profit production for the benefit of its portfolio shareholders. Economically, firms exist as 'joint ventures' or 'partnerships' of the firms' continuously changing owners, the portfolio shareholders that is, who have 'outsourced' the management of their 'joint venture' to the firm's management. The presence of a firm's corporate management representing the firm entails that a firm may actually be considered to exist as a venture, economically separate from its shareholders.

Accordingly, the firm can be seen as a separate economic operator – an agent with a governance structure – to be distinguished analytically from its owners, i.e., the portfolio investors that financed the firm's underlying integrated cross-border business operations with equity.[89] A firm may comprise of a single legal entity or a group of economically integrated legal entities under the common control of an ultimate parent company. If the firm has business activities in more than one country – and has foreign direct investments – it is typically labeled as a multinational firm, multinational enterprise, or plainly as a multinational.

It may be acknowledged that the firm's equity investors, the owners, do not operate the business through their corporate interests themselves. The owners of the firm merely hold their interest as a portfolio investment as they are primarily interested in the economic return on their shareholdings rather than in the underlying business operations of the firm.

[85] See on the question of why to tax corporations in the first place, Richard M. Bird, 'Why Tax Corporations?', 56 *Bulletin for International Taxation* 194 (2002), at 194-203 and Ruud de Mooij, 'Will corporate income taxation survive?', 3 *De Economist* 153 (2005), at 292.

[86] See Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 41 and 156.

[87] See for a comparison Michael J. McIntyre, 'Thoughts on the Future Of the State Corporate Income Tax', 25 *State Tax Notes* 931 (23 September 2002), at 936-938, and Peter Harris, 'The CCCTB GAAR: A Toothless Tiger or Russian Roulette?', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012), at 278.

[88] Avi-Yonah adopts the argument of a firm's existence to argue that the imposition of a corporate tax is justified as a means to control the excessive accumulation of power in the hands of corporate management. See Reuven S. Avi-Yonah, 'Corporations, Society and the State: A Defense of the Corporate Tax', 90 *Virginia Law Review* 1193 (2004), at 1193-1255.

[89] This can be considered true to the extent that it concerns a publicly, or widely, held company. With respect to a controlling shareholding in a privately, or closely, held company, the presence of one economic operator may be argued, i.e., the investor and company seen in conjunction. This is the case in which the shareholder/taxpayer holds a controlling corporate interest in the company through which the business enterprise is carried on for the purpose of employing that controlling interest it for the benefit of its underlying business enterprise on a continuing basis.

A portfolio shareholder makes equity capital available to the firm so that the firm can pursue its direct investment activities as an entrepreneur. In return, the shareholder is remunerated, i.e., it receives proceeds from its portfolio equity capital investment in the form of dividends and capital gains upon the disposal of its corporate interest. The investor mainly holds the portfolio investment interest as a security. The underlying property, business or other activities of the firm in which the interest is held is of secondary importance to the shareholder. The shareholder typically does not care too much about the types of investments undertaken by the multinational firm; as long as they are profitable.

The firm itself, through its corporate management, carries on the business enterprise by means of its direct investments. The firm together with its portfolio shareholders does not make up the economic entity as the multinational firm operates its enterprise as the economic entrepreneur, separate from its investors. Accordingly, the firm is a homogenous economic value creator – i.e., rather than a mere conduit of income derived by its portfolio investors.[90]

As the firm constitutes a single economic unit, it perhaps should be treated as a single unit, separate from its owners, for tax purposes notably as the firm and its portfolio shareholder can be seen to constitute separate economic units. This allows the assessment of the corporation tax on a stand-alone basis. That is, separate from the other taxes in a country's 'tax mix'. The relationships between the corporation tax and the income and consumption taxes levied from the firm's shareholders and workers are not reviewed in this study. The integration of corporate taxation and individual income taxation is not analyzed either. The same applies for the relation between corporate taxation and consumption taxation, for instance to mitigate or resolve tax cascading issues in these areas. These matters are left untouched as they are outside of the confines of the central research question of this study.

Multinational firms derive economic rents

A third response to the cynic could be that the multinational firm as a single economic entrepreneur derives economic rents. By operating business activities in a functionally integrated manner on a global scale, firms have proven able to produce so-called above-normal investment returns, commonly also referred to as 'pure profits', 'inframarginal returns' or 'above-normal returns', 'excess earnings', 'business cash-flow', or 'economic rents'. Firms derive these rents, i.e., these earnings or economic value increases in excess of the normal return rates to the production factors of labor (wage) and capital. Standard low-risk return rates on capital, for instance are yields on savings deposits or government bonds. The above normal return rates may be seen as the remuneration for the production factor of enterprise (for more on economic rents see Chapter 5).

As the multinational firm produces rents it makes sense to tax these rents derived from the firm directly through the corporate tax system – instead of taxing these rents indirectly in the hands of its portfolio shareholders. Just as workers pay tax on their earnings – wage taxes –, the production factor of labor and portfolio investors pay tax on the returns on capital – capital income taxes – the production factor of capital, it may be considered sensible to also tax firms on their returns on the production factor of enterprise, its rents that is. The perspective may accordingly be taken that the corporation tax should be included in the tax mix to finance the public goods and services provided by the state from which the multinational also benefits.

Avoid 'fairness spillovers' to other taxes in the tax mix

The final response to the cynic could be the following. The fairness question cannot be denied in corporate taxation. That is to avoid something that may be referred to as 'fairness spillovers' to other taxes in the tax mix.

Let us assume that a taxing authority for whatever reasons and on whatever grounds were to introduce a corporation tax and no notions of fairness would be taken into account. In doing

[90] See for a comparison Richard J. Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World', 2 *World Tax Journal* 291 (2010), at 293-294, who links this rationale to the theory of the firm.

so, the tax authority would adopt a non-equitable and non-neutral tax. Such a tax would operate arbitrarily, spilling over to the other taxes in the tax mix such as the wage tax, the capital income tax, or the consumption tax. Would that be a problem? The answer to that question may very well be in the affirmative.

Were the corporation tax to operate arbitrarily – it would for instance be unable to sufficiently tax the multinational firm's economic rents, thereby creating tax arbitrage – the taxing authority that seeks to raise revenue to finance expenditure would need to resort to alternative means. It would for instance resort raising wage taxes and consumption taxes, or the levies on real estate. The absence of fairness in the corporate tax – i.e., the presence of inequity and non-neutrality in it – would accordingly have some spill-over effects into the other taxes in the tax mix. That would render the alternative taxes unfair as well, i.e., inequitable and distortive.

Such fairness spill-overs from the corporate tax into the other taxes in the mix that would follow from neglecting the fairness in corporate taxation would render matters perhaps even more difficult than *a priori* addressing them. The unfair leakages into the other taxes in the tax mix would have to be addressed. The arbitrage created in corporate taxation would need to be fixed somewhere else in the mix. And, indeed, this may be considered the case under the current international tax regime. As it seems impossible to properly tax the rents that multinationals derive from their global operations, the tax burdens imposed on consumption and labor are simply increased in response to that in order to finance public expenditure. Those increases are commonplace. We are unable to tax the firm, so we tax the consumer and the worker instead.

In sum, the issues of fairness cannot be escaped by simply arguing that fairness is absent in corporate taxation. The issue may even be reinforced to avoid that the questions on fairness would just be transferred to another context. That would perhaps render things only worse as it would give rise to the additional, perhaps insurmountable, issue of measuring the level of unfairness in the other levies in the mix to compensate for the unfair corporation tax system created. The issue can only be dealt with by accepting that the notions of fairness equally apply in corporate taxation; if not on moral grounds then perhaps for pragmatic reasons.

2.2.1.2 Fairness in tax theory corresponds to the notions underlying the European Union

Before elaborating on the constituent parts of the following section, it is worth noting that the notions of fairness, i.e., equity and economic efficiency, also lie at the heart of the legal framework on which the European Union has been built.[91] The cornerstone objectives underlying the European Union – which align with the common values of the Member States – correspond to the notions on which international tax theory has been based, at least indirectly. Please let me elaborate on this and devote a few words to the matter.

The objective of the European Union is the same as the objective of a typical constitutional democratic sovereign nation state. The European Union seeks to promote the well-being of the people living within its geographic territories.[92] For that purpose, the European Union seeks to establish an area without internal frontiers on the basis of common social and economic policies to ensure fair, i.e., equitable, and free, i.e., economically efficient, competition. This entails that all publicly induced distortions in the functioning of the internal market without internal frontiers need to be eliminated.[93]

To enhance equity and economic efficiency within the internal market – put in the perspective of direct taxation by the Member States – the direct tax systems of the European Union

[91] See for comparison, Peter Harris et al, *International Commercial Tax* (2010), at 96.
[92] See the preamble to the Treaty on European Union (TEU) and Article 3 TEU. For some further analysis see Frans Vanistendael, 'No European Taxation Without European Representation', 9 *EC Tax Review* 142 (2000), at 142.
[93] Article 2 Treaty on European Union in conjunction with Articles 26 and 119 Treaty on Functioning of the European Union. Cf. Court of Justice, case 15/81 (*Gaston Schul).*

Member States need to be harmonized.[94] At the same time, where European Union law applies, the abolition of all unilaterally imposed obstacles to cross-border movements of goods, services, persons and capital is required; the European Union's 'free movements' or 'fundamental freedoms'. The area without internal frontiers has been established as a means to reach these objectives. The European Union is an autonomous supranational legal order. European Union law has direct effect in the respective domestic legal orders of the European Union Member States.[95]

However, today, harmonization of the direct taxation systems of the European Union Member States has been attained only to a very limited extent. With the exception of the prohibition of state aid and a few Directives, the competences in the area of direct taxation currently completely lie at the level of the European Union Member States. A basic property of European Union law in the field of direct taxation is that when the European Union was founded no competences to levy direct taxes were transferred from the Member States to the Union. Today, the European Union Member States have veto power with respect to any European Commission proposal that involves a transfer of sovereignty in the field of direct taxation to the European Union.[96] Consequently, within the internal market without internal frontiers, fiscal sovereignty is fragmented into as many autonomous tax jurisdictions as the European Union has Member States – currently twenty-eight. In direct taxation, a true internal market without internal frontiers does not exist (yet). It is a 'work in progress'. Accordingly, the sovereignty of the Member States in the field of direct taxation does not substantially differ from the sovereignty of non-European Union Member States in this field.

This nevertheless does not change the reality that European Union law has a profound influence on the international tax systems of the Member States. The established case law of the Court of Justice of the European Union reveals that the Member States have to exercise their competence in direct taxation consistently with the free movement rights.[97] Where the Treaty on the Functioning of the European Union is applicable, any obstacles imposed by the Member States are incompatible with the principle of free movements, unless these obstacles can be justified under the treaty or the 'rule of reason' – i.e., by overriding reasons in the general interest, for instance, on the basis of anti-tax abuse considerations.

Consequently, the Member States are competent to decide whether or not to tax and to distribute this competence to tax amongst each other through double tax conventions, as long as they adhere to the principles of free movements.[98] This means that – like non-European Union Member States – the Member States of the European Union are sovereign in their decisions on who to tax (taxable entity), what to tax (tax base) and at which rate (tax rate). They are also sovereign in their decision on which taxing principle (i.e., source, residence,

[94] See Title VII Treaty on Functioning of the European Union. See for a comparison Frans Vanistendael, 'Memorandum on the taxing powers of the European Union', 11 *EC Tax Review* 120 (2002). Notably, the free movement of capital extends to third countries. The persons and territory falling under the free movement of capital is universal. See Articles 63-66 Treaty on Functioning of the European Union. Consequently, Member States are not allowed to discourage economic activities beyond the external borders of the European Union and the European Economic Area (the European Union Member States plus Iceland, Liechtenstein and Norway) – i.e., relative to intra-European Union and intra-European Economic Area equivalents – to the extent that the legal transactions/movements qualify as capital movements. The Member States are not allowed to restrict or discriminate these capital movements, save for the application of the standstill provision. See Article 64 Treaty on Functioning of the European Union. External cross-border capital movements fall under the free movement of capital, with the exception of restrictive and discriminatory measures in respect of 'direct investments' in place in the laws of the Member States as at December 31, 1993. Before this date, there was no provision in Community law that directly applied to capital movements involving third countries. See for some analysis on the application of the freedom of capital in third country situations Erwin Nijkeuter et al, 'FII 2 and the Applicable Freedoms of Movement in Third Country Situations', 22 *EC Tax Review* 250 (2013), at 250-257.

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

[96] Article 115 Treaty on Functioning of the European Union.

[97] See Court of Justice, cases C-336/96 (*Gilly*), C-446/03 (*Marks & Spencer II*), C-265/04 (*Bouanich*), C-307/97 (*Saint Gobain*) and C-170/05 (*Denkavit Internationaal*). The same applies under the case law of the European Freed Trade Association ('EFTA') Court re the Member States of the European Economic Area. See EFTA Court, case E-7/07 (*Seabrokers*).

[98] Cf. Frans Vanistendael, 'In Defense of the European Court of Justice', 62 *Bulletin for International Taxation* 90 (2008), at 90-98, Frans Vanistendael, 'Memorandum on the taxing powers of the European Union', 11 *EC Tax Review* 120 (2002), at section 3 and Frans Vanistendael, 'Common (Tax) Law of the Court of Justice', 16 *EC Tax Review* 250 (2007), at 250-251.

nationality) to apply to base tax jurisdiction upon. However, the manner in which these decisions are subsequently expressed in that respective Member State's international tax system falls within the competence of the European Union. This means that the Court of Justice is competent to examine the international tax systems' operation as to their compatibility with the fundamental freedoms.[99]

The Court of Justice's case law on direct tax matters reveals a significant legal difference between European Union Member States and non-European Union Member States. European Union Member States have to answer to a court that is competent to rule on obstacles that are incompatible with the fundamental freedoms. In cases in which the Treaty on the Functioning of the European Union is applicable, the Court of Justice can accordingly force the Member States to eliminate any unilaterally imposed obstacles in their international tax systems. Under the fundamental freedoms intra-European Union cross-border business activities may not be taxed differently from intra-European Union domestic business activities under the international tax systems of the Member States. Consequently, this supranational legal framework has a profound effect on the Member States' tax policy decisions. Non-European Union Member States are not legally required to answer to such a supranational court. In that context there is no legal framework which can force non-European Union Member States to eliminate any obstacles from their international tax systems. The absence of such a legal framework, however, does not mean that no obstacles conceptually exist in the international tax systems of non-European Union Member States. Absent a legal authority, there is just no one to tell those countries to get rid of them.

Nevertheless, in my view, the European Union's notions of equity and economic efficiency within the internal market may have a general effect in the development of ideas on a fair allocation of tax in a global market. It is true that the European Union is a supranational legal framework that is unique in the world. Obviously, European Union law has no legal effect outside the scope of application of the Treaty on European Union. But the European Union is not built on unique values. It is built on notions shared by twenty-eight developed countries in an internal market without internal frontiers. And it may be appreciated that it is somewhat hard to understand how matters conceptually need to be different for the constitutional countries adhering to the rule of law outside the context of the European Union and its internal market, but nevertheless within the reality of an emerging global marketplace where production factors effortless flow across country tax-borders.

The European Union experiences and the attempts undertaken to dissolve the distortions in the functioning of the internal market that have been induced by the operation of the direct taxation systems of the Member States – indeed, together with its perhaps far-reaching consequences in practice – may therefore also have a meaning outside the geographic area of the European Union. Accordingly, the conceptual horizon is merely extended beyond the geographical borders of the European Union and the operation of its legal framework. That is to translate its underlying notions to a universal level. Why not?

2.2.2 What does equity mean?

2.2.2.1 The obligation to contribute to the financing of public expenditure

Equity is an ethical concept, based on equality, i.e., the basically universally accepted notion of equal treatment before the law.[100] Everyone in an economic relationship with a taxing state

[99] In its role as a constitutional court guaranteeing and interpreting the fundamental freedoms, the Court of Justice brings the international tax systems of the European Union Member States closer to each other – negative integration. See Klaus Vogel, 'Which Method Should the European Community Adopt for the Avoidance of Double Taxation?', 56 *Bulletin for International Taxation* 4 (2002), at 10, and Frans Vanistendael, 'Common (Tax) Law of the Court of Justice', 16 *EC Tax Review* 250 (2007), at 251. See also Peter Harris et al, *International Commercial Tax* (2010), at 39.

[100] See Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part I & III)', 8/9 *Intertax* 216 (1988), at 216-228 and 11 *Intertax* 393 (1988), at 393-402. More in detail see Nancy Kaufman, 'Fairness and the Taxation of International Income', 29 *Law and Policy in International Business* 145 (1998), at 145-203 and Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapters 1 and 2 and Victor Thuronyi, 'The Concept of Income', 46 *Tax Law Review* 45 (1990), at 45-105.

has the moral obligation to contribute to the financing of public goods from which one benefits – i.e., the 'benefits principle' adhering to income tax or corporate income tax as an *in rem* tax, in accordance with one's means – i.e., the 'ability to pay principle' adhering to the income tax or corporate income tax as an *ad personam* tax.

The term 'everyone' is addressed in more detail in Chapter 4, in which the question is assessed of who should pay corporate tax. Without going into detail here, it should be noted that in my view the taxpayer for corporate tax purposes should correspond to the economic operator, the economic entity deriving business income.[101] To the extent corporate taxation of multinational firms is concerned, it is the multinational that should be treated as the tax entity for corporate tax purposes.

'One's means' is described in more detail in Chapter 5, i.e., the question of what to tax in corporate taxation. Although I will not go into detail here, in my view the tax base should align with the Schanz-Haig-Simons concept of income.[102] According to this concept, income is a substitute for measuring well-being which cannot be measured objectively. Individual well-being is therefore measured in substitute terms of income, defined as an increase of economic power – the creation of economic wealth by the provision of production factors – as increased economic power can be measured objectively. Furthermore, most people would tend to agree that a higher standard of living enhances one's satisfaction with life – although such a view may perhaps also be considered somewhat materialistic. Insofar as the concept of income focuses on business proceeds, the concept of income basically seems to resort to business cash flow or economic rent as the remuneration for the enterprise factor of production.[103]

Furthermore, it is worth noting that the term 'benefit principle' addresses the connection between the imposition of tax and the public goods provided in return, although the benefits are individually immeasurable. Without entering into the details at this place – the matter is assessed in depth in Chapter 6 – it should be noted that the income tax should be levied at the location that corresponds to the income's geographical source as closely as possible.[104] In this study the benefits principle, notably, is seen in its broadest sense. The interpretation of the benefits principle is not restricted to payments to a governmental body which directly result in the provision of governmental services – i.e., retributions. In addition, it is worth noting that the 'ability to pay principle', as addressed in this study, simply refers to one's actual ability to pay the tax due. Is the economic operator solvent; is the firm involved in fact able to pay the corporate tax due?[105]

2.2.2.2 Inter-taxpayer equity and inter-nation equity

In international tax theory, the concept of equity comprises two dimensions: inter-taxpayer equity on the one hand and inter-nation equity on the other hand.[106]

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[101] See also Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 12.
[102] See Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapter 1.
[103] See for a comparison Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 44. See for a comparison Peter Harris et al, *International Commercial Tax* (2010), at 46 and 72.
[104] See Alvin Rabushka, 'The Flat Tax', in International Economic Conference Progress Foundation 2000, *The Flat Tax: American and European Perspectives* (2000) 3, at 7, and Alvin Rabushka, *A Simplified Tax System; The Option for Mexico (Essays in public policy no. 38)* (1993), at 11.
[105] See for a comparison Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 34: *"The ability to pay principle is not limited to individuals. It applies equally to the taxation of business of any legal form."*
[106] See further Michael J. Graetz, 'The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies', 54 *Tax Law Review* 261 (2001), at 297-307, Nancy Kaufman, 'Fairness and the Taxation of International Income', 29 *Law and Policy in International Business* 145 (1998), at 145-203, Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part I)', 8/9 *Intertax* 216 (1988), at 216, Klaus Vogel, '"State of Residence" may as well be "State of Source" – There is No Contradiction', 59 *Bulletin for International Taxation* 420 (2005), at 420-423, Klaus Vogel, 'Which Method Should the European Community Adopt for the Avoidance of Double Taxation?', 56 *Bulletin for International Taxation* 4 (2002), at 4-8, See Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 824-828, Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapter 1, Niv Tadmore, 'Source Taxation of Cross-Border Intellectual Supplies

Inter-taxpayer equity: horizontal and vertical inter-taxpayer equity

Inter-taxpayer equity seeks a fair allocation of tax among taxpayers.[107] This dimension of equity has been developed in a domestic context. The equality principle forms the normative point of departure. Economic equal circumstances *in se* should be treated equally and unequal economic circumstances *in se* should be treated unequally insofar as circumstances are unequal.

Within the context of inter-taxpayer equity, a distinction is typically made between horizontal and vertical inter-taxpayer equity. Horizontal inter-taxpayer equity requires that taxpayers who derive equal amounts of income pay equal amounts of tax. *"If two taxpayers earn identical incomes, this doctrine of equity would imply that each should contribute identical shares in taxation."*[108] Vertical equity requires that taxpayers in unequal circumstances are appropriately taxed bearing these unequal circumstances in mind. Different amounts of income should be subject to different amounts of tax. The tax burden imposed should further reflect some degree of progressiveness. As the utility of marginal income declines, it would be fair to subject marginal income items to a progressive tax rate.[109] It should be noted that inter-taxpayer equity does not seem to be based on independent principles or features of tax fairness. The equality principle calls for equal treatment in equal circumstances, as well as unequal treatment in unequal circumstances insofar as the circumstances are unequal. Horizontal and vertical inter-taxpayer equity accordingly both boil down to the same underlying notion of equality.

In my view, both the ability-to-pay principle and the benefits-principle result from the notion of inter-taxpayer equity.[110] An example may illustrate this. Let's say that corporate taxpayer 'Shoe Sales Company' operates a shoe selling business enterprise around the corner. The equality principle requires that Shoe Sales Company is entitled to the exact same corporate tax treatment as, let's say, corporate taxpayer 'Taxi Company' who operates a taxi service business enterprise across the street. Both equally benefit from public goods provided – public order, infrastructure, legal system, a market to service, et cetera. Therefore, both should equally and proportionally contribute to the funding of these public goods. In case they realize a profit, they should be liable to pay corporate tax to a certain amount in accordance with their ability to pay. In the event that they suffer a loss, they should not have to pay tax as they are not able to pay tax and may even go bankrupt when the tax authorities force them to do so.

Some notes on optimal tax theory

Notably, it may be worth submitting the following remarks on optimal tax theory at this point.[111] Optimal tax theory fairly appreciates that each individual taxpayer has different

– Concepts, History and Evolution into the Digital Age', 61 *Bulletin for International Taxation* 2 (2007), at section 2, Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006), at section 2, and Dale Pinto, 'Exclusive Source or Residence-Based Taxation – Is a New and Simpler World Tax Order Possible?', 61 *Bulletin for International Taxation* 277 (2007), at 277-291, at section 2. See for a comparison Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 001Rev1**,** *General Tax Principles,* Taxud-E1 – TN, CCCTB/WP\001Rev1\doc\en, Brussels, 10 December 2004, at 1-6. Finally, see Robert L. Palmer, 'Toward Unilateral Coherence in Determining Jurisdiction to Tax Income', 30 *Harvard International Law Journal* 1 (1989), at 2-22. The concepts of horizontal and vertical equity are left out of consideration.

[107] See for a comparison Nancy Kaufman, 'Fairness and the Taxation of International Income', 29 *Law and Policy in International Business* 145 (1998), at Chapters 1 and 2. See also Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapter 1, at 19-20.

[108] See Alvin Rabushka, 'The Flat Tax', in International Economic Conference Progress Foundation 2000, *The Flat Tax: American and European Perspectives* (2000) 3, at 4, and Alvin Rabushka, *A Simplified Tax System; The Option for Mexico (Essays in public policy no. 38)* (1993), at 5.

[109] The effective marginal tax rate notably should not be 100% though, to not take away the incentive to pursue personal welfare increases.

[110] Notably, the same holds in my view as to the principles of legality and legal certainty – these are not to be further discussed. See on this matter Frans Vanistendael, 'Legal Framework for Taxation', in Victor Thuronyi (ed.), *Tax Law Design and Drafting*, International Monetary Fund (1996) 15, at chapter 2.

[111] This paragraph draws from Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapter 1.

characteristics, opportunities and tastes, including things like physical and mental capacity, life expectancy, education levels, environmental influences, health, and leisure time. All of these contribute to or detract from that person's well-being.

Optimal tax theory therefore sets forth that the unequal possession of these characteristics necessarily entails the imposition of corresponding unequal tax burdens. Accordingly, optimal tax theorists seek to achieve inter-taxpayer equity based on difficult to specify, perhaps somewhat subjective criteria. How can it be objectively determined whether one person is well-off compared to someone else? Whilst conceptually appealing, this line of reasoning has not been adopted in this study.

This study seeks to address fairness in taxation by referring to income in terms of accrued economic power as a measurable proxy for immeasurable well-being. Furthermore, the cost of taxation is considered to be distributed fairly if allocated to taxpayers that find themselves in equal economic circumstances, i.e., in terms of income levels measured as accrued economic power, prior to the imposition of tax.

The question of how to adjust for inter-taxpayer inequalities in terms of mutually diverging social characteristics that make up a person's individual well-being is left untouched in this study. Such a correction, although perhaps conceptually desirable, should be achieved through political processes in my view; for instance by way of deciding on the tax rates to be applied, or via the expenditure side of fiscal policy. Furthermore, as this study seeks to tax the business proceeds of multinational firms, which necessarily lack attributes of social well-being – it seems sufficient to look at its economic value creation by reference to the production of increased economic worth in monetary terms.

Inter-nation equity

Inter-nation equity seeks a fair allocation of tax between states.[112] This dimension of equity has been developed in a cross-border context within the confines of the present system of sovereign nation states. It takes fiscal sovereignty as a given due to the lack of a supranational body with sovereign taxing powers. More than one taxing state is involved. Let us again take Shoe Sales Company into mind. Shoe Sales Company is taxed as a corporate taxpayer by a certain country. It operates a shoe selling business around the corner but its place of effective management is abroad. And take into mind again Taxi Company, which is also taxed as a corporate taxpayer by a certain country but this company has its place of effective management in that country. It operates a taxi service business enterprise across the street, which happens to be on the other side of the (tax) border.

In international taxation a different tax residence of a corporate taxpayer is generally considered to constitute a different circumstance.[113] Both the domestic tax systems and the double tax conventions networks of basically all countries worldwide follow this assumption. Accordingly, international taxation is based on the basic approach that the situation of residents and non-resident taxpayers is different and can therefore legitimately be subjected to different tax treatment. As a consequence for instance, only taxpayers that are resident of one of the countries that are party to a double tax convention concluded may invoke the application of the tax treaty. Furthermore, taxpayers are typically subject to a different tax treatment by reference to their tax residence – i.e., the unlimited tax liability of resident taxpayers versus the limited tax liability of non-resident taxpayers. The starting point, hence, is the existence of tax borders and a different tax treatment depending on where the taxpayer has its tax residence. Both Shoe Sales Company and Taxi Company would receive a different

[112] See for a comparison Nancy Kaufman, 'Fairness and the Taxation of International Income', 29 *Law and Policy in International Business* 145 (1998), at Chapters 1 and 3.
[113] See the Commentary on Article 24 of the OECD Model tax Convention at par. 7. See on this matter Mary C. Bennett, 'The David R. Tillinghast Lecture; Nondiscrimination in International Tax Law: A Concept in Search of a Principle', 59 *Tax Law Review* 439 (2005 - 2006), at 439-486. Bennett argues that Article 24 of the OECD Model Tax Convention provides for an incoherent set of rules, which unlike European Union law lack an overarching rationale. See on this matter also Ruth Mason, 'Tax Discrimination and Capital Neutrality', *2 World Tax Journal* 126 (2010), at 126-138, as well as Hugh J. Ault et al, 'Taxation and Non-discrimination: A Reconsideration', *2 World Tax Journal* 101 (2010), at 101-125.

tax treatment, compared to each other as well compared to their competitors at home and abroad.

Why is that? What difference should residence make to the question of a fair imposition of corporate tax in a global market; conceptually? I do not know to be honest. My response would be: none. I fail to see why a taxpayer's tax residence would constitute a different circumstance and therefore justifies this different tax treatment. In today's reality where economic operators move increasingly effortlessly across tax-borders in an emerging global market place, the tax residence is economically immaterial. The tax residence should be insignificant in a global market (although it does not in reality, as, it matters a lot in corporate taxation where a company resides for tax purposes). In an increasingly borderless world, there is no reason why the presence of a tax-borders and the tax place of residence should continue to be this conceptual stronghold to argue differences in circumstances. The paradigm in my view can only be explained by reference to dogmatic reasoning based on yesterday's economic realities.

In my view, the notion of equality as applicable within the internal market under European Union law is much more up to date, as it appreciates and adheres to the concept of the internal market without internal frontiers. The European Union and its free movement rights fundamentally aim to remove any distortions caused by the presence of tax-borders within a frontierless internal market. Hence, for the purposes of applying the principle of equality it is essentially sufficient that situations are materially similar under European Union law – for instance irrespective of a taxpayer's place of residence.[114]

Inter-nation equity has its normative foundation in the equality principle as well. However in international tax theory it is generally referred to and labeled differently as the principle of non-discrimination. However, the difference between the equality principle and the non-discrimination principle may simply be the labels used. The difference may just be of a terminological nature.

This means that again both the benefits principle and the ability to pay principle ensue from this equal treatment concept.[115] Please let me briefly elaborate on this. Corporate taxpayers Shoe Sales Company and Taxi Company both benefit from public goods provided. Therefore they should contribute to the financing of the public goods both here and abroad as they are economically present and subject to tax both domestically and abroad. Also, their tax contribution should be equal to those of the taxpayers that decided to keep things local and not cross the border. Otherwise the taxpayers would receive unequal tax treatment when compared to each other. The difference in treatment would merely result from the economic operator's decision to either cross the tax-border or not – which should be considered immaterial in a global marketplace.

Keeping the equality principle separate from the operation of legal rules and constructs

I fail to see why corporate taxpayers who conduct their business activities in a cross-border context should find themselves in different circumstances for tax purposes compared to corporate taxpayers who conduct their business activities entirely in a domestic context. Both operate businesses in the global market. The presence of a man-made tax border is conceptually immaterial in this respect.

[114] See also Commission of the European Communities, Commission Staff Working Paper, *Company Taxation in the Internal Market*, Brussels, 23 October 2001, SEC(2001) 1681, at 309-310.

[115] I do not see why the benefits principle and the ability to pay principle would not be interrelated – or why these notions should not be taken into account – for the mere reason that it concerns the taxation of corporate income realized in a cross-border context (rather than in a purely domestic context). Notably, this view does not correspond with the approach recognized in the OECD Model Tax Convention and the UN Model Tax Convention on income and capital. These promote a limited tax liability under the source principle and an unlimited tax liability under the residence principle. That is, a divergent tax treatment on the basis – solely – of a difference of the involved taxpayer's place of tax residence.

Please let me devote some words to this. An analysis of a rule or legal construct against the equality principle requires a comparison of the circumstances to be set off against the operation of the assed legal rule or construct. The normative requirement of tax parity in economic equal circumstances, the 'test', should be kept analytically separate from the differences in legal treatment in a particular scenario. That is because the difference in the legal treatment is the object of the assessment; the issue under discussion – the 'test object'. If legal differences would seep into the analysis, the differences in the legal treatment would affect the outcome of the assessment. The difference in legal treatment could then even be utilized to argue the inequality of the circumstances: 'the circumstances differ as the legal treatment differs; hence there is no equal treatment issue'. Such reasoning would be logically invalid. It would essentially cancel out the equality principle in law. The point made is much like the observation that the numbers in a calculation should not affect the underlying mathematical rules as the numbers could then affect the mathematical outcome and thus set aside the mathematical rule.

Translated to fairness in corporate taxation, this means that the tax effects in a particular scenario should be kept analytically separate from the fairness concept, as the tax effects constitute the object against which the equality principle is offset. Only that approach allows a normative analysis of the tax effects without having the tax effects affecting the outcome of the assessment. Again, much like the outcome of a calculation not affecting the underlying mathematical rules that direct that outcome.

At the end of the day, the sovereignty of states, and hence the presence of tax-borders is a legal construct. There is no inherent moral truth behind it. As borders are man-made, they can also be removed legally by mankind. The existence of the European Union as a supranational body to which the Member States have transferred parts of their sovereign entitlements proves this thesis. Accordingly, domestic and cross-border business activities of corporate taxpayers need to be compared without taking the presence of the tax-border, a legal construct, into consideration. And in doing so – bearing in mind a globalizing economy – I fail to recognize why circumstances of the aforementioned business activities of our corporate taxpayers, Shoe Sales Company and Taxi Company, are considered different circumstances from those of their domestic peers just because they have decided to take their business operations across a legal construct such as a tax-border.

No tax burden differential dependent on intra-firm legal organization

Furthermore, equity requires that a group of affiliated corporate entities which jointly, i.e., as a single economic operator, carries on a single integrated business enterprise should be subject to an overall tax burden that corresponds to the tax burden that an independent corporate entity, operating a similar business, is subject to. This approach is commonly referred to as the 'unitary business approach'[116] and broadly adhered to in the literature.[117] The unitary business approach may be recognized in tax grouping regimes seeking to treat the affiliated group of corporate bodies as a single tax entity. Tax grouping regimes can be found in the international tax systems of various states. The same approach may also be recognized in the Common Consolidated Corporate Tax Base (CCCTB) project undertaken within the European Union's institutions. This matter is further addressed in Chapter 4.

Please note that it is conceptually impossible to reconcile the unitary business approach with the separate entity approach and the functionally separate entity approach under which affiliate corporate bodies are taxed as if they were separate taxable entities and permanent

[116] The US Supreme Court considers the 'unitary business principle', i.e., the notion of recognizing the firm to constitute a single unit for corporate tax purposes regardless of its legal organization, *"the linchpin of apportionability in the field of state income taxation"*. See United States Supreme Court, *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S. Ct. 1223 (1980), at 439. For some historical background and analysis, see Jerome R. Hellerstein, 'State Taxation Under the Commerce Clause: the History Revisited', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 53, at 53-81. See further Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al, *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 245-298.

[117] See Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 828.

establishments are considered distinct and separate enterprises for tax base attribution purposes.[118] The same is true with regards to the subsequent recognition of inter-company transactions and internal dealings for which an at arm's length transfer price must be determined.[119] This subject matter is dealt with in Chapters 4 and 6 respectively.

The single tax principle

Moreover, equity requires that business income is taxed only once – 'the single tax principle'.[120] It is unfair to tax economic rents more than once or less than once. Both 'overtaxation' and 'undertaxation' are unfair. As income is earned only once it should also be taxed only once. *"Income should be taxed only once, as close as possible to its source (as any economic activity that is taxed more than once will be discouraged while those that are not taxed will be favored. This is both unfair and inefficient. Double taxation distorts costs and prices, interferes with production decisions.)"*[121]

This holds true in both a domestic and a cross-border context. It would be unfair if taxpayers Shoe Sales Company and Taxi Company would be taxed twice on their income earned or less than once, only because of their decision to cross a tax-border.

2.2.3 What does economic efficiency mean?

2.2.3.1 Tax should not affect economic decisions

Neutrality as to where to produce and sell

Economic efficiency provides an economic foundation for a fair allocation of tax among taxpayers and between states.[122] Economic efficiency presupposes that the productivity of income is the highest, and with that, also the fairest when production factors and consumption are distributed on the basis of market mechanisms without public interference or as little public interference as possible. The concept of neutrality as regards the question of where to produce and sell has also been referred to in the literature as 'market neutrality' or 'global optimality'.[123]

For the purposes of taxation, economic efficiency requires that *"taxes should distort as little as possible the prices resulting from the interaction of supply and demand in the market. Tax policy should strive for neutrality between investment and consumption and among products and industries. Government should not use its power to alter prices to favour any one industry or producer."*[124] Corporate taxation should merely follow the economic presence of an

[118] See Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 276-280 and Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', 62 *Bulletin for International taxation* 201 (2008), at 202-203.
[119] See Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at section 3.
[120] See for a comparison Reuven S. Avi-Yonah, 'Tax Competition, Tax Arbitrage and the International Tax Regime', 61 *Bulletin for International Taxation* 130 (2007), at 131, and Reuven S. Avi-Yonah, *International Tax as International Law; An Analysis of the International Tax Regime* (2007), at Chapters 1 and 10 and Klaus Vogel, '"State of Residence" may as well be "State of Source" – There is No Contradiction', 59 *Bulletin for International Taxation* 420 (2005), at 420-423. See also Yariv Brauner, 'BEPS: An Interim Evaluation', 6 *World Tax Journal* 10 (2014), at 28.
[121] See Alvin Rabushka, 'The Flat Tax', in International Economic Conference Progress Foundation 2000, *The Flat Tax: American and European Perspectives* (2000) 3, at 7, and Alvin Rabushka, *A Simplified Tax System; The Option for Mexico (Essays in public policy no. 38)* (1993), at 11.
[122] See Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part II)', 10 *Intertax* 310 (1988), at 310-320, Klaus Vogel, 'Which Method Should the European Community Adopt for the Avoidance of Double Taxation?', 56 *Bulletin for International Taxation* 4 (2002), at 4-8 and Michael J. Graetz, 'The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies', 54 *Tax Law Review* 261 (2001), at 269-294. See Robert L. Palmer, 'Toward Unilateral Coherence in Determining Jurisdiction to Tax Income', 30 *Harvard International Law Journal* 1 (1989), at 2-22.
[123] See Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 700, 707-708, and 716.
[124] See Alvin Rabushka, 'The Flat Tax', in International Economic Conference Progress Foundation 2000, *The Flat Tax: American and European Perspectives* (2000) 3, at 4, and Alvin Rabushka, *A Simplified Tax System; The Option for Mexico (Essays in public policy no. 38)* (1993), at 5.

economic operator and the economic value it creates. Taxation should not affect business decisions – neither in a positive nor in a negative manner.

This holds both in domestic and cross-border business environments. *"From a theoretical perspective, if income derived from cross-border transactions is taxed more heavily than domestic income, the added tax burden creates an inefficient incentive to invest domestically. This proposition is widely accepted and underlies the effort, which by now is about a century old, to prevent or alleviate international multiple taxation. The corollary also holds true: If income from cross-border transactions is taxed less heavily than domestic income, this creates an inefficient incentive to invest internationally rather than at home. The deadweight loss from undertaxation is the same as that from overtaxation. In addition, there is also a strong equity argument against undertaxation of cross-border income."*[125]

An optimal tax, therefore, is a tax that does not result in welfare reducing market distortions, or limits these distortions were possible – i.e., the notion of tax neutrality.[126] *"Production is allocated efficiently throughout the world if it is not possible to reallocate resources between activities in a way that would increase total output"*.[127] The idea is essentially that market forces should continue to operate as if no taxes were levied.

The open market economy and the welfare benefits of globalization are not reviewed in this thesis. Empirical studies and historical developments broadly illustrate that free trade and competition enhance competition, improve efficiency in the allocation of production factors and stimulate firms to innovate.[128] Surely, not everybody wins. But on an overall basis the opening up of domestic markets is widely held to have increased public welfare and with that the well-being of many.

Neutrality as to intra-firm legal organization of business; neutrality of legal form

Economic efficiency also requires the neutrality of legal form.[129] That is because intra-firm legal aspects are superfluous when it comes to determining the amount of earnings of the firm involved. At the end of the day, legal aspects such as the limited or unlimited liability under company law are irrelevant when it comes down to the question of how much profit the firm has produced. It is, for instance, true that the limited liability ensuing from the operation of economic activities through subsidiary companies enables the firm to take greater economic risks – potentially allowing it to produce a higher profit level. However, the limited liability itself is irrelevant when it comes to the question of how much profit the firm has derived. Corporate profit is a quantitative variable.

Corporate taxation seeks to tax corporate earnings, i.e., the accrued economic value as a result of engaging in economic activity by a company. Intra-firm legal realities do not play a role in the calculation of the amount of accrued economic value. Intra-firm legal realities are superfluous when it comes to determining the amount of corporate or other earnings. Accordingly intra-firm legal realities should be of no relevance also in the determination of the level of the taxable profits derived.

In sum, the manner in which the business activities undertaken are structured legally should be irrelevant when levying corporate tax. *"The income of a common enterprise should be*

[125] See Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 518 et seq.
[126] Please note that it is appreciated that tax imposts by definition entail behavioral responses, e.g. on leisure, consumption and saving. This issue is left untouched. See Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 30-40.
[127] See Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 700.
[128] See e.g. Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 11.
[129] See Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part II)', 10 *Intertax* 310 (1988), at 319.

taxed without regard to its organizational structure". [130] Intra-firm legal affairs should not influence the firm's corporate tax base. The firm's internal legal organization should accordingly be of no relevance for the answer to the question of how much economic wealth the firm has created.[131]

Tax neutrality implies no room for tax instrumentalism

The question of whether taxation may or should be used to influence taxpayer behavior – tax instrumentalism – is answered in the negative in this study.[132] Politically it may be considered desirable to make use of the tax system as a regulatory tool. This explains tax instrumentalism, i.e., the making use of the tax system as a tool to steer taxpayer behavior.

Conceptually however, there is no room for this regulatory function of taxation. At least not in corporate taxation when tax instrumentalism results in unequal tax treatment in equal economic circumstances. The Schanz-Haig-Simons concept of income defines business income in terms of economic accrual or economic rent. In my view, an impost on accrued economic power, an objective economic phenomenon should be levied for the sole purpose of raising revenue to finance public expenditure. Political desires to steer or regulate the underlying economic phenomenon, i.e., regulatory aims, should be expressed in regulations, subsidies, fines or penalties, instead of in the tax system. Instrumentalism should accordingly be dealt with on the expenditure side of fiscal policy if so desired by society.

Illustrative for the approach taken at this point are the illegal state aid rules in European Union law.[133] These rules prohibit the selective granting of beneficial tax treatment – tax subsidies– to certain industries or branches of economic activity to attract corporate investment.[134]

Tax neutrality implies that no room exists for tax competition

The neutrality principle dictates that taxation should not influence business decisions. The current international tax regime seeks to tax business proceeds at the investment location. Practice shows that countries use their international tax systems to mutually compete rather than to mutually cooperate. Countries compete in the area of taxation to attract and preserve investment within their geographic territories; the 'race for the tax base'.[135] Tax competition

[130] Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 292.
[131] Contra general reporter Masui in International Fiscal Association, *Cahiers de Droit Fiscal International* (*Volume 89b*, *Subject II (Group taxation))* (2004), at 35-36.
[132] For an analysis of the function of taxation as a regulatory tool, see Reuven S. Avi-Yonah, 'The Three Goals of Taxation', 60 *Tax Law Review* 1 (2006-2007), at 22-25.
[133] See Article 107 Treaty on Functioning of the European Union. For some further reading and analysis, reference is made to Peter J. Wattel, 'Forum: Interaction of State Aid, Free Movement, Policy Competition and Abuse Control in Direct Tax Matters', 5 *World Tax Journal* 128 (2014), at 128-144, Pasquale Pistone, 'The Growing Importance of the Prohibition of State Aid in Tax Matters', 40 *Intertax* 84 (2012), at 84, Pierpaolo Rossi-Maccanico, 'Fiscal Aid Review and Cross-Border Tax Distortions', 40 *Intertax* 92 (2012, No. 2) at 92-100, Conor Quigley, 'Direct Taxation and State Aid: Recent Developments Concerning the Notion of Selectivity', 40 *Intertax* 112 (2012, No. 2), at 112-119, and Raymond H.C. Luja, '(Re)shaping Fiscal State Aid: Selected Recent Cases and Their Impact', 40 *Intertax* 120 (2012, No. 2), at 120-131.
[134] European Union Member States are not allowed to selectively tax-favor certain industries or branches of economic activity as these impede a neutral and fair flow of economic activity within the internal market. Examples of regimes potentially constituting illegal fiscal state are the selective granting of 'tax holidays', 'accelerated allowances', and the establishment of 'tax free zones' regarding certain types of economic activity. On this matter, see e.g. Commission notice 98/C 384/03, OJ C 384 of 10 December 1998, at 3, and Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation, C(2004) 434 of 9 February 2004.
[135] Reference can be made to Michael P. Devereux, 'Business taxation in a globalized World', 24 *Oxford Review of Economic Policy* 625, (2008), at 625-638 and Michael P. Devereux et al, 'Taxing Multinationals', *National Bureau of Economic Research Working Paper* 2000:7920. Worth mentioning also is Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010. Auerbach notes the steady decline of US corporate tax revenues as a share of national income, as well as the international pressure – also felt in the US – to reduce rates to attract foreign investment. Further, see Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), at section 4.2. Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, find support for concluding that tax revenues in corporate income weighted by gross domestic product remained broadly stable. This is not further discussed.

between states is essentially incapable of enhancing the efficiency of the current international regime.

In the current origin oriented international tax regime seeking to tax firms at the investment location, the tax competition phenomenon drives average effective tax rates and corporate tax revenues downwards, ceteris paribus.[136] This means that in all manifestations of tax competition, the international tax regime, in its current manifestation may ultimately force the effective tax rate on business proceeds to nil – the 'race to the bottom hypothesis'.[137] Logics prescribe the recognition of states playing a zero sum game. By attracting business activities to a certain state through granting tax incentives inevitably mutual spill-over effects are triggered. The tax-induced attraction of investment to one state would necessarily be at the expense of another. A favorable tax climate in one state equals a revenue cost in the other.

Accordingly, little conceptual basis exists for the commonly acknowledged differentiation in tax law between harmful and – apparently – 'unharmful' tax competition.[138] There is no conceptual dividing line between harmful and unharmful tax competition. That is, at least to the extent it is desired to tax firm rents in a globalized economy. The difficulties that both the OECD and the institutions of the European Union encounter in defining what should be considered 'harmful tax competition' in an unbiased manner under their 'soft law' approaches, adopted to tackle this phenomenon, are illustrative in this respect.[139]

It seems that nation states may only compete with each other when they try to attract foreign investment through optimizing nation state administrative net outputs. That is, the level of efficiency in respect of the cost of government incurred where a sovereign state administratively fulfils its distributive tasks.[140] Then, the tendency will be to direct investment towards the state with the lowest tax costs to public goods ratio, i.e., the most efficiently arranged government.

2.2.3.2 Neutrality in corporate taxation matches equality in corporate taxation

As with equity, the tax neutrality principle may considered to be founded on the equality principle as well. Accordingly the tax neutrality principle requires equal tax treatment in economic equivalent circumstances; economic equality in taxation that is. Under the

[136] See on this matter, for instance, Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006; 264, and Michael P. Devereux et al, 'Corporate income tax reforms and international tax competition', 17 *Economic policy* 450 (2002, No. 35), at 450-495, who find evidence in support of the hypothesis that effective tax rates have fallen on profitable investment – which may be explained by reference to downwards pressures on statutory tax rates felt by governments in response to a fall in the cost of income shifting and governmental tax competition responses to multinational firm investment location decisions involving profitable projects.

[137] On the phenomenon of tax competition in international and European taxation see Michael Keen et al, *Chapter 5 – The Theory of International Tax Competition and Coordination*, in Alan J. Auerbach et al (eds.), *Handbook of Public Economics*, Vol. 5, Elsevier B.V., 2013, 1-474, at 257-328, George R. Zodrow et al, 'Pigou, Tiebout, property taxation, and the underprovision of local public goods', 19 *Journal of Urban Economics* 356 (1986, No. 3), at 356-370, John D. Wilson, 'A theory of interregional tax competition', 19 *Journal of Urban Economics* 296 (1986, No. 3), at 296-315, John Douglas Wilson, 'Tax competition with interregional differences in factor endowments', 21 *Regional Science and Urban Economics* 423 (1991, No. 3), at 423-451, and Joel Slemrod et al, 'Tax competition with parasitic tax havens', 93 Journal of Public Economics 1261 (2009, No. 11/12), at 1261-1270. See further, e.g., Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38. It seems that corporate rates have declined over the past decades, amongst others, because of more intense competition between states for attracting MNEs' mobile production factors. Empirical evidence verifies the reality of tax competition and declining tax rates. See for some analysis Michael P. Devereux et al, 'Do countries compete over corporate tax rates?', 92 *Journal of Public Economics* 1210 (2008), at 1210-1235, who argue that countries simultaneously compete over effective marginal tax rates for capital and over effective average tax rates for profit. See for a comparison Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 7.

[138] See, for instance, the references to European Union and OECD attempts made by Schön; see Wolfgang Schön, 'International Tax Coordination for a Second-Best World (Part I)', 1 *World Tax Journal* 67 (2009), at 78-79.

[139] See for some analysis, e.g., Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

[140] Contra, Wolfgang Schön, 'International Tax Coordination for a Second-Best World (Part I)', 1 *World Tax Journal* 67 (2009), at 78-79.

foundation concept of income adhered to in this study, the choice has been made to subject economic wealth accrual to taxation as a substitute for measuring well-being. This implies that the ability to pay principle and the benefits principle result from the neutrality concept also. The proceeds from each business activity should be taxed equivalently. That is because unequal corporate tax treatment in equal economic circumstances – hence, inequality – distorts business decisions and therefore the distribution of production factors.

Inequitable corporate tax treatment is economically inefficient, and therefore distortive. Equity and neutrality are interchangeable concepts as both ensue from the same underlying notion, i.e., the notion that equal economic circumstances should be treated equally. Why would a profit-driven economic operator for instance decide to engage in a certain business activity if it were to be confronted with a comparatively burdensome unequal corporate tax treatment on the proceeds derived from this activity? Suppose that our shoe seller mentioned above would be treated less favorably for tax purposes. Shoe Sales Company would be subject to a higher tax burden on its income compared to our taxi services enterprise Taxi Company. Rationally, Shoe Sales Company would cease its shoe selling activities and start a taxi service business as Taxi Company did, ceteris paribus. It would be rewarded with an increase of its after-tax profit. Hence, unequal corporate tax treatment influences business decisions.

As unequal tax treatment influences the behavior of economic operators, I find it hard to recognize a trade-off between equity and economic efficiency – i.e., other than sometimes argued in the literature. That is to say, at least not within the context of corporate income taxation.

Let me illustrate this with another example, this one regarding progressive tax rates. In my view tax rate progressiveness as called upon by vertical inter-taxpayer equity may evenly be based on economic theory. Under the law of diminishing or declining marginal utility, the perceived value or utility of a good declines with each additional unit acquired. The first euro or dollar of income derived by a taxpayer has a high degree of utility. The second, third, and basically each marginal euro or dollar of income derived has a progressively lower marginal utility for the taxpayer. This means that a progressively higher tax levied on a marginal increase of each unit of income derived, in terms of utility has the effect of enhancing equality in respect of the tax burden imposed. As the utility of a marginal item of income declines, a higher amount of tax should be levied to effectively reach the same tax burden imposed, i.e., in terms of utility. Although nominally higher the tax burden would substantially be the same, in terms of utility that is. This also explains why flat income tax rates are often considered to have a regressive effect in terms of utility. Accordingly, as taxation can be seen as an instrument available to the government to redistribute individual well-being to optimize the collective well-being of the population, wealth transfers from the more well-off to the less well-off via the fiscal system under progressive tax rates may not only be based on equity grounds but on economic theory as well, i.e., the law of diminishing marginal utility. The rationale of declining marginal utility may accordingly be seen as to also apply, at least derivatively, within the context of a corporate tax. After all, a corporate tax in fact operates as an advance levy to the individual income tax.[141]

2.2.3.3 Pursuing worldwide economic efficiency

Various commentators have argued that sovereign states should pursue worldwide economic efficiency.[142] The gist is that no state should attempt to use its tax competences to change relative prices in the other state any more than it would in the absence of taxes, as this would

[141] On the corporate tax as a pre-levy see also Ruud A. de Mooij et al, 'Corporate tax policy and incorporation in the EU', 15 *International Tax and Public Finance* 478, at 479.

[142] See Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part II)', 10 *Intertax* 310 (1988), at 310 and Klaus Vogel, 'Which Method Should the European Community Adopt for the Avoidance of Double Taxation?', 56 *Bulletin for International Taxation* 4 (2002), at 5. See for a comparison Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 232-233. See for a comparison also 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*, COM(2001) 582 final, 23 October 2001, at 15.

be at the expense of both itself as well as the foreign nation state.[143] This means amongst others that neither the economic operator's place of residence nor the place of its business activities should influence the way in which the taxpayer is effectively taxed.

In a global market, worldwide efficiency and national efficiency go hand in hand. The national and international income tax system of a default state is, or at least should be founded on ideas on an international tax policy that serves the well-being of that state's people in the broadest sense. As described above the same objective has been pursued by the European Union.

An internationally competitive national open market benefits from an undistorted internationalization of domestic business. The strive for national economic efficiency simultaneously entails the strive for worldwide economic efficiency. Consequently, the pursue of worldwide efficiency should be a cornerstone of a state's national and international tax policy and its national or international income tax system in today's emerging global marketplace.

2.2.4 Administrative convenience; getting rid of the red tape

In addition to the concepts of equity and economic efficiency, the principle of administrative convenience, or simplicity is generally recognized as one of the principles of sound taxation as well.[144] It basically requires the tax system produces as little red tape as possible. *"The notion of simplicity encompasses the comprehensibility of the system, the ease with which taxpayers can figure out how much they owe with absolute certainty, and how much time and effort they have to put into complying with the tax system. It reflects the extent to which taxpayers have to consult expert counsel from their lawyers or accountants either to compute their taxes or to take advantage of tax-saving devices."*[145]

Administrative convenience may be viewed from two perspectives, that of the tax administration and that of the taxpayer. The tax authorities seek administrative convenience when assessing the corporate tax liability of the corporate taxpayer. The taxpayer seeks administrative convenience when complying with the tax laws. In a globalizing economy, obligations for taxpayers to provide information on their international business income, as well as agreements between states on mutual administrative assistance and cooperation, obviously are of significant importance. This is also true for legal remedies available to taxpayers under domestic law and under mutual agreement procedures and international arbitration procedures laid down in international agreements, for example, the relevant provisions in bilateral tax conventions and the many tax information exchange agreements worldwide in place. Within the context of European Union one may think of the Arbitration Convention in Connection with the Adjustment of Profits of Associated Enterprises and the European Union Directives on mutual administrative assistance in tax matters.[146] Moreover, the parties involved should obviously be entitled to litigate unresolved matters through an independent judicial system at all times.

Simplicity or administrative convenience arguments, however, in my view do not have the same hierarchical status as the equality principle. The principle of equal treatment before the law should not be refuted on the basis of administrative convenience arguments.[147] The

[143] See for some analysis, e.g., Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.
[144] See Robert L. Palmer, 'Toward Unilateral Coherence in Determining Jurisdiction to Tax Income', 30 *Harvard International Law Journal* 1 (1989), at 12 et seq, and Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 829. Cf. Court of Justice, cases C-101/05 (*Swedish A)* and C-446/04 (*FII*).
[145] See Alvin Rabushka, 'The Flat Tax', in International Economic Conference Progress Foundation 2000, *The Flat Tax: American and European Perspectives* (2000) 3, at 4, and Alvin Rabushka, *A Simplified Tax System; The Option for Mexico (Essays in public policy no. 38)* (1993), at 5.
[146] See e.g. Council Directive 2011/16/EU of 15 February 2011 and Council Directive 2010/24/EU of 16 March 2010.
[147] Cf. the Dutch Supreme Court, Hoge Raad, 9 January 2009, No. 43 758, published in the unofficial tax reporter Vakstudie-Nieuws 2009/7.5, where the Dutch Supreme Court did not consider administrative difficulties in assessing tax in cross-border scenarios a justification for the unequal tax treatment of resident taxpayers in comparison with non-resident taxpayers in equal circumstances.

principle of administrative convenience plays a role in support of the principle of equality. It should not be the other way around.

The principle of administrative convenience fulfils a different role than the notions of equity and neutrality. The simplicity argument is of a practical nature – it seeks to reduce red tape. It deals with the question *whether tax can be assessed* without insurmountable practical difficulties. Other than for equity and neutrality, the principle of administrative convenience does not see to the normative question *how tax should be allocated* among taxpayers and between states. In that respect, the principle of administrative convenience may only impose practical limitations to efforts pursuing equity and neutrality in practice. Hence, a theoretically sound, i.e., an equitable and economically efficient, distribution of tax cannot be contaminated with arguments of an administrative convenience nature. Practical problems ask for practical solutions. The equality principle provides the will, simplicity the way.

2.3 Fairness requires international coordination, but fiscal sovereignty

2.3.1 International coordination required

The notions of equity and neutrality as set forth in the above call for a coordination of the international tax regime. Only common approaches in the international tax law design can sufficiently secure the single taxation of business income and may accordingly promote global efficiency.[148]

It may even be said that to arrive at true equal tax treatment in economic equal circumstances this would conceptually require a globally harmonized corporation tax system.[149] *"In a real world situation in which there are cross-border flows of portfolio and direct investment, and also international trade, than all traditional forms of taxation would be distorting unless they were completely harmonized. (…) [M]arket neutrality (…) holds if taxes do not distort competition between companies; that is, one company does not derive a tax-induced competitive advantage over another. It is clear from this analysis that market neutrality would require full harmonization of source and residence corporation taxes."*[150] Only a full global harmonization of the international tax systems of countries can overcome the distortions in the allocation of corporate tax among taxpayers and between states in a global market place – i.e., the obstacles, disparities and inadequacies referred to in Chapter 1 of this study.[151]

2.3.2 Suggestions and proposals forwarded for a corporate tax 2.0 by others

Prior tax scholarship has produced a range of suggestions and proposals to arrive at a coordinated alternative international tax regime.

Various commentators have for instance advocated a unitary business approach to come to a system where basically the multinational group is treated as a single tax entity for corporate

[148] Cf. Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 232-233. See also European Commission, 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*, COM(2001) 582 final, Brussels, 23 October 2001, at 15.
[149] See Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 635.
[150] Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 707.
[151] See Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 700, 707 and 716. Notably, the similar argument has been used to advocate using uniform formulae in US state taxation, see Bharat Anand et al, 'The weighting game: formula apportionment as an instrument of public policy', 53 *National Tax Journal* 183 (2000), at 183-199, as well as Austan Goolsbee et al, 'Coveting thy neighbor's manufacturing: The dilemma of state income apportionment', 75 *Journal of Public Economics* 125 (2000), at 127 and 142. See also Joann M. Weiner, 'Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level', 13 *Tax Notes International* 2113 (23 December 1996), at 2137. Weiner refers to the investment location distortions that arise under the present non-harmonization of state formulae in the US.

tax purposes.[152] That would allow for a global tax consolidating (or a regional alternative) or otherwise cross-border pooling of taxable profits.[153]

A coordination of the consolidated taxable base of multinational firms should by no means be impossible to achieve. *"Theoretically, income should be determinable on a uniform basis. Definitions of income or net income may differ between countries, but this does not mean that such differences cannot be reconciled. Worldwide consolidated financial accounting clearly represents an effort to do so."*[154] Indeed, *"[f]inancial accounting and tax accounting methods frequently differ materially. Given that each is directed to serve a different purpose this is not surprising. The preparation of consolidated financial statements, however, demonstrates that the consolidated or combined tax statements can be prepared and the reconciliation of tax and book or financial income is a common requirement on most tax returns."*[155] *"If problems exist … the answer is not to abandon the unitary method but to adopt more appropriate measures."*[156]

The so determined multinational firm's global tax base would subsequently be divided among the respective tax jurisdictions in which the firm is active on the basis of a profit allocation key. That key should reflect the economic presence of the multinational within the relevant tax jurisdiction. That is because the tax should be levied as closest as possible to its geographic source.

It has been suggested that this profit division key should be based on the 'profit split or residual profit split method' in transfer pricing, producing a tax allocation mechanism referred to as a 'global profit split'.[157] It has also been suggested to use a predetermined fixed formula – an approach that is referred to as 'global formulary apportionment'.[158] It has further been

[152] See the following four footnotes.

[153] See e.g., Maarten F. de Wilde, 'A Step towards a Fair Corporate Taxation of Groups in the Emerging Global Market', 39 *Intertax* 62 (2011), and Sol Picciotto, 'Transfer pricing is still dead ... From Independent Entity Back to the Unitary Principle', 73 *Tax Notes International* 13 (6 January 2014), at 18.

[154] See Benjamin F. Miller, 'Worldwide Unitary Combination: The California Practice', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 132, at 150. See also Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at section 4.2.3.

[155] Ibidem at 154.

[156] Ibidem at 150.

[157] See e.g., Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997) at 510 who suggests some sort of global profit split by reference to functions performed. See further Antonio Russo, 'Formulary Apportionment for Europe: An Analysis and A Proposal', 33 *Intertax* 1 (2005), at 1-31, who proposes a pan-European residual profit split as an alternative to the Commission proposals for European Union wide formulary apportionment under its CCCTB Project. See also David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 1: The Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 55 (2004), as well as David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 2: Solutions to Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 235 (2004). Francescucci arrives at using multilateral RPSM to capture the multinational efficiency premium. He does not seem to go as far to propose global profit splits, though. Finally, see for a comparison OECD, *Revised discussion draft on transfer pricing aspects of intangibles*, 30 July 2013, OECD, Paris, 2013 in which the OECD seems to move towards establishing an analysis from the perspective of the multinational's worldwide business operation, i.e., at least within the context of allocation profits from intangible asset commercialization. At par. 151: *"The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE's global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business."* See also OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Guidance on Transfer Pricing Aspects of Intangibles*, Paris, 16 September 2014. Notably, Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, argues at 264 that *"[t]he OECD has been promoting, with the support of the financial services industry, the use of a formula for assigning financial services income derived from global trading of financial instruments to particular taxing jurisdictions."*

[158] See e.g., Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286, Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', 62 *Bulletin for International Taxation* 201 (2008), at 201-215, Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 103-111, Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, as well as Sol Picciotto, 'Transfer pricing is still dead ... From Independent Entity Back to the Unitary Principle', 73 *Tax Notes International* 13 (6 January 2014), at 18, and Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002). Notably, Li seems to (purposely) employ the term 'global profit split' not in the typical meaning of profit split as commonly used in transfer pricing, but actually to propose some form of formulary apportionment, i.e., allocation on the basis of a formula reflecting the economic factors that

advanced in the literature to combine the two – i.e., the split of the residual profit by reference to a metric formula.[159] Notably, the European Commission proposal of 16 March 2011 for a Common Consolidated Corporate Tax Base ('CCCTB') envisages a harmonized European Union-wide cross-border consolidated corporate taxable base to be shared among the Member States by reference to a formulary apportionment mechanism also.[160] The purpose hereof is to achieve equity and neutrality in the field of corporate income taxation within the territories of the European Union.[161]

One difficult aspect that must be taken into consideration is that the allocation key should adequately tie down a firm's geographical presence. This is exactly what the current international tax regime fails to accomplish. In the event that a newly developed allocation key would be unable to achieve this, it would be as inadequate as the current one. In which case, the allocation of tax between states would still not be in accordance with economic reality.

This looming scenario inspired Auerbach, Devereux and Simpson to propose even more radical changes: a business income tax based on cash flows, the 'destination-based cash flow tax'.[162] Such a tax would subject economic rents to tax and for tax base allocation purposes it would be linked to the goods supplied and the services rendered by economic operators at the customer location. It would function conceptually in a manner akin to a destination-based value added tax system based on cash flows rather than on invoices. And any wages paid would effectively be tax-deductible.

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contribute to profit making. Also Cockfield mentions this, see Arthur J. Cockfield, 'Formulary Taxation versus the Arm's Length Principle: The Battle Among Doubting Thomases, Purists, and Pragmatists', 52 *Canadian Tax Journal* 114 (2004), at 115. For a proposal to adopt a formulary approach on the level of the North American Free Trade Association, see, e.g., Paul R. McDaniel, 'Formulary Taxation in the North American Free Trade Zone', 49 Tax Law Review 691 (1993-1994), at 691-744. Also Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 843, refers to McDaniel. See further Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, who mentions the alternative of employing formulary approaches at regional levels as well (NATA, EU), i.e., at 246 and 293-293. McIntyre further refers to Robert S. McIntyre et al, 'Using NAFTA to Introduce Formulary Apportionment', 6 *Tax Notes International* 851 (1993), at 851-856, and Mike McIntyre, 'Harmonizing Direct Taxes in the EEC', 2 *Tax Notes International* 131 (1990), at 131-132. See also Alicia Munnell, 'Taxation of Capital Income in a Global Economy: An Overview', *New England Economic Review* 33 (1992), at 33-51, and Charles E. McLure, Jr., 'Economic Integration and European Taxation of Corporate Income at Source: Some Lessons from the U.S. Experience', 29 *European Taxation* 243 (1989), at 243-250. The application of a formulary approach on regional bases, sometimes referred to as 'water's edge', may perhaps be pragmatically and politically more feasible than its global alternative. However, regional approaches trigger profit allocation issues at the regional borders. That is, since at these borders SA/ALS would apply, thereby analytically re-introducing the issues accompanying its use in a manner as elaborated upon extensively in the above subsections. Cf. Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 258. See also Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

[159] See, e.g., Nobert Hezig et al, 'Between extremes: Merging the Advantages of Separate Accounting and Unitary Taxation', 38 *Intertax* 334 (2010), at 334, who make a plea for employing ALS for routine transactions and to supplement it with FA where necessary, thereby benefitting from the advantages of both attribution methodologies while to some extent limiting their disadvantages. See also Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', *2 World Tax Journal* 3 (2010), at 3-18. Avi-Yonah proposes a compromise, a hybrid ALS/FA-system at 3: *"Use FA in the context of the ALS. Specifically, I would suggest using FA to allocate the residual profit in the profit split method"*. Further, see Michael Mazerov, 'Why arm's length falls short', 5 *International Tax Review* 28 (1994), at 30, François Vincent, 'Transfer Pricing and Attribution of Income to Permanent Establishments: the Case for Systematic Global Profit Splits (Just Don't Say Formulary Apportionment)', 53 *Canadian Tax Journal* 409 (2005), at 409.

[160] See Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM (2011) 121/4, 2011/0058 (CNS). For a comparison and analysis, see Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 001Rev1**,** *General Tax Principles,* Taxud-E1 – TN, CCCTB/WP\001Rev1\doc\en, Brussels, 10 December 2004, at 1-6 and CPB Document 141, *Will corporate tax consolidation improve efficiency in the EU?*, 2007, at 1-87.

[161] See European Commission, 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*, COM(2001) 582 final, Brussels, 23 October 2001, and Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, *An Internal Market without company tax obstacles achievements, ongoing initiatives and remaining challenges*, COM(2003)726 final, 24 November 2003.

[162] See Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), at 62.

The potential alternatives to the current international tax regime are discussed in more detail in Chapters 4, 5 and 6. Notably, if corporate tax rates would also be coordinated, any tax rate disparities would be cancelled out as well. In such a case, it would become completely insignificant for corporate income tax purposes where a corporate taxpayer resides for tax purposes or where it carries on its business operations geographically. Regardless of the geographic location of the firm, its investments, or its supplies of goods and services, its effective average tax rate would always be identical. All distortions in the allocation of tax among taxpayers would accordingly be taken away. As taxation would cease to distort the geographic distribution of production factors in that event, such an approach would not only be supported by equity arguments, but also by tax neutrality arguments.[163] Indeed, *"as long as each company faces the same effective corporate tax rate on all its investments then location decisions will not be distorted."*[164]

2.3.3 But fiscal sovereignty…

Attaining some sort of augmented level of coordination of the international tax systems of countries as said has a price. It necessarily needs to be accompanied with a transfer of autonomy in the field of direct taxation to some sort of a supranational body. That body would set, execute and enforce the rules, and would subsequently settle any disputes that arise.[165]

This position may be illustrated by reference to the work done in approximating the tax systems of countries within the context of the European Union. In the end, the pursue of the shared objective of the Member States and the European Union to obtain a true internal market without internal frontiers requires the transfer of sovereignty to the Union.[166] Illustrative are the harmonization efforts undertaken by the European Commission – efforts effectively necessitating autonomy transfers from the Member States to the European Union. No room exists for tax borders in an internal market without internal frontiers.

However, the 1920s Compromise on which basis the current international tax systems of countries, including those of the European Union Member States, are currently built is quintessentially based on the sovereign entitlements of nation states to levy tax to finance expenditure. This has resulted in the current tax borders. Indeed, today's reality of twenty-eight different international tax systems of as many European Union Member States set-up alongside tax borders analytically cannot coincide with the pursue of an internal market without internal frontiers. Each difference in the tax burden regarding intra-European Union business activities relative to purely domestic business activities involves a distortion of the internal market. A distortion in need to be removed through an approximation of the Member States' corporate tax systems.[167]

An internal market without internal frontiers can only be realized through a uniform European Union Company Income Tax ('EUCIT').[168] Equivalently, a borderless global market can only function under a global corporation tax. Seen from this perspective, the sovereignty of states in direct tax matters today – and with that, an allocation of corporate tax alongside tax borders

[163] See Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 635. See for a comparison Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 001Rev1**,** *General Tax Principles,* Taxud-E1 – TN, CCCTB/WP\001Rev1\doc\en, Brussels, 10 December 2004, at 1-6 and CPB Document 141, *Will corporate tax consolidation improve efficiency in the EU?*, 2007, at 1-87.
[164] See Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 706.
[165] See for a comparison Vito Tanzi, 'Is there a need for a World Tax Organization?', in Assaf Razin et al (eds.),*The economics of globalization: policy perspectives from public economics*, Cambridge University Press, 1999, at 173-186. Notably, the question of how to organize such a supranational body, respecting the trias politica, is not further discussed.
[166] Cf. Frans Vanistendael, 'No European Taxation Without European Representation', 9 *EC Tax Review* 142 (2000), at 142-143 and Frans Vanistendael, 'Memorandum on the taxing powers of the European Union', 11 *EC Tax Review* 120 (2002), at 120-129.
[167] See for a comparison Sijbren Cnossen, 'Om de toekomst van de vennootschapsbelasting in de Europese Unie', 125 *Weekblad Fiscaal Recht* 871 (1996), at section 4.
[168] See Commission of the European Communities, Commission Staff Working Paper, *Company Taxation in the Internal Market*, Brussels, 23 October 2001, SEC(2001) 1681, at 14.

– is a pragmatic, preliminary, alternative for a genuine global market. The same holds true for the internal market without internal frontiers.[169] Hence, as it currently stands, European Union law in the field of direct taxation finds itself in a transitional period. The same is true for the international tax regime. There is no difference between the fiscal sovereignty of states in the internal market and the fiscal sovereignty of states in the global market.

Regardless of the theoretical soundness, or lack thereof, of the coordination suggestions advanced in the literature and the harmonization proposals of the European Commission, today, they all merely exist on the drawing board. And chances are that this will remain so for the time being. It perhaps is not very realistic to assume any proposals will be adopted anytime soon.

The reason for this is that a transfer of competences in taxation necessarily implies a transfer of sovereignty for international law public purposes. After all, the fiscal sovereignty of a state is a quintessential feature of the concept of a state in international law. A state cannot function without the power to tax. And today, states prove unwilling to give up their sovereignty in corporate tax matters. This is true, both globally and regionally (e.g. within the European Union.

Illustrative is the legislative constraint within the context of the European Union where the Member States on the one hand express the objective to approximate tax legislation requiring a transfer of sovereignty to the union, while the same Member States on the other hand seek to maintain their competence to levy direct taxes – illustrated by the Member States' unanimous vote upon the passing of European Union tax legislation.[170] It is no coincidence that the harmonization of direct taxation within the European Union has been kept limited to only a few Directives and the Arbitration Convention; and only time will tell whether the Member States will truly be willing to adopt the Commission proposals for a Common Consolidated Corporate Tax Base.

But as long as the suggestions and proposals remain on the drawing board, fairness will not exist in the reality. The market distortions that result from the obstacles, disparities and inadequacies in the nation states' international tax systems will linger on as long as they are not resolved. The status quo will effectively be upheld as long as states remain unwilling to resolve the problems that they have created. This however does not mean that we should stop thinking about an optimal international tax regime.

2.4 Final remarks

This chapter addresses the question of how to understand the notion of fairness in international corporate taxation. What constitutes the benchmark to assess the fairness or unfairness of the international tax regime? What are the principles underlying a sound tax system?

It is argued that the notion of fairness in corporate taxation is founded on the equality principle, thereby conforming to the historically widely acknowledged notion of equal treatment before the law. Economic equal circumstances should be treated equally for tax purposes. Unequal economic circumstances should be treated unequally for tax purposes insofar as the circumstances are unequal.

[169] See for a comparison Frans Vanistendael, 'Denkavit Internationaal: The Balance between Fiscal Sovereignty and the Fundamental Freedoms?', 47 *European Taxation* 210 (2007). See for a comparison also Court of Justice, cases C-319-02 (*Manninen*), C-446/03 (*Marks & Spencer II*), C-168/01 (*Bosal*), C-524/04 (*Thin Cap GLO*) and C-527/06 (*Renneberg*). Contra Court of Justice, case C-250/95 (*Futura*) and D.M. Weber, *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC* (2006), at 11-18. Weber argues by pointing at the *Futura* case that unilaterally imposed market distortions resulting from European Union Member States expressing the territoriality principle in their international tax systems are disparities.

[170] Article 115 Treaty on Functioning of the European Union.

From the equality postulate it can be deduced that everyone in an economic relationship with a taxing state has the obligation to contribute to the financing of public goods from which one benefits in accordance with one's means – 'equity'. And production factors should be distributed on the basis of market mechanisms without, or at least with as little as possible, public interference – 'economic efficiency'. Taxation should be in line with economic reality; it should not affect business decisions – tax neutrality, including the neutrality of legal form. Income should be taxed once, as close as possible to its source.

It has further been set forth that:

- in a global market environment it should be irrelevant for corporate tax purposes where the economic operator has its place of residence for tax purposes. It should also be irrelevant whether or not the economic operator involved performs its business activities in a cross-border context – see further Chapter 3;
- the taxable entity for corporate tax purposes should correspond to the economic operator deriving the business income. If it concerns the taxation of a multinational firm, the firm should be treated as the taxable entity for corporate tax purposes – see further Chapter 4;
- the tax base should be designed by reference to a foundation income concept that truly focuses on business income. It should tax business cash flows or economic rents, as these constitute the remuneration for the production factor of enterprise – see further Chapter 5;
- the tax should be levied once at the location that corresponds to the income's geographical source as closely as possible – see further Chapter 6.

Moreover, the argument has been made that fairness in corporate taxation may ultimately only be achieved through a worldwide coordination of country tax systems. Indeed, various scholars have suggested possible approaches to achieve this means. The suggestions range from global profit splits to destination based cash flow taxes. The European Commission envisages a European Union wide cross-border consolidated corporate tax base to be shared among the Member States by reference to a formulary mechanism.

Indeed, it perhaps cannot be expected that any of these suggestions will leave the drawing board any time soon. Nation states seem politically unwilling to give up their sovereign entitlements in the field of direct taxation; a necessary prerequisite to achieve some form of tax approximation. Perhaps, the tax sovereignty of states should be taken as a given. That is to say, at least to some extent, for instance with regards to establishing the tax rate (see further Chapter 6).

This however does not mean that political realities provide a sufficient argument to stop thinking about an optimal international tax regime. As long as the suggestions put forward continue to exist on the drawing board only, fairness in corporate taxation will not be achieved in reality. As long as nation states remain unwilling to resolve the problems that they have created, the status quo will not change. The problems in the international tax regime will not be resolved by adhering to political realities. *"Political opposition should be recognized for what it is."*[171] Let us proceed.

[171] See Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', *2 World Tax Journal* 3 (2010), at 15.

Part III – Towards a fair international tax regime; eliminating obstacles

– Chapter 3 –

Towards a fair international tax regime; eliminating obstacles

Chapter 3 Towards a fair international tax regime; eliminating obstacles

3.1 Introduction[172]

Chapter 2, the first analytical part of the analysis in this study, concludes with the observation that the concepts of equity and neutrality in corporate taxation ultimately call for a coordination of the international corporate tax systems of nation states. Tax coordination necessarily involves the acceptance of an erosion of the nation state competences to design their corporate tax systems autonomously though. Tax coordination requires states to align their tax systems and calls for bilateral or multilateral action.

Were the starting point of thinking be taken that such bilateral or multilateral action, for whatever reason, is unattainable the following question arises. What could, or perhaps should states unilaterally do to remove the distortions in their international tax systems created by themselves? How could countries mitigate the obstacles they unilaterally impose when they tax corporate income from sources earned by multinationals in their respective territories?

The analysis in this chapter builds on the analytical assumption that the fiscal sovereignty of states is taken as a given. State sovereignty in taxation forms the departure point of the analysis. It follows that also the environment of an uncoordinated international tax regime should be taken as a given, i.e. an international tax regime that comprises of as many disparate international tax systems as there are sovereign nation states. What could individual states unilaterally do to advance the fairness of their own international tax systems? The second analytical part of this study contained in this single Chapter 3 is devoted to answering this question.

This chapter accordingly addresses the unilaterally imposed obstacles in the international tax systems of states that hinder the functioning of the global market. As identified in Chapter 1, obstacles arise when the international tax systems of states internally impose a different tax treatment on cross-border business activities relative to domestic business activities. The absence of tax parity in domestic and cross-border economic environments is the effect of unilateral tax legislative action.

As states impose these obstacles unilaterally, they can also resolve them unilaterally. Coordination is unnecessary in this area as countries do not need each other to resolve the obstacles in their own tax systems. This is conceptually true for the obstacles in the international tax system of any state – i.e., of the countries that are a member of the European Union and of the countries that are not. The mere difference in the legal reality of European Union countries and non-European Union countries is that European Union law has made available a remedy to counter the obstacles in the tax systems of the Member States in the form of the fundamental freedoms. Where European Union law and its free movement rights apply, the Court of Justice is competent to strike down the discriminatory and restrictive obstacles in the Member States' international tax systems. Where European Union law does not apply, obviously, no legal remedy is available as it the case for the obstacles in the tax systems of the states that are not party to the European Union. But the lack of a legal remedy in these contexts does not mean that obstacles are conceptually absent in these contexts.

Drawing inspiration from what I consider the best elements of existing theories, concepts and practices in international tax law and European Union law, it is argued in this chapter that a nation state's international tax system should be internally fair. The argument accordingly is built on a concept of 'tax fairness within the international tax system of a state'. For this

[172] This chapter draws from the following of my papers: Maarten F. de Wilde, 'Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy', 38 *Intertax* 281 (2010), 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, 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.

purpose, the equality principle is explored as it is addressed within the European Union under the fundamental freedoms, and the interpretation thereof by the Court of Justice. The notion of tax fairness within the international tax system boils down to something that is referred to as 'internal equity' and 'internal production factor neutrality' in this study.

The widely known tax policy concepts of the neutrality of the import and export of capital and labor are assessed as well to prove that tax neutrality is actually absent under these two concepts. Import neutrality promoting tax systems distort production factor exports. Export neutrality promoting tax systems distort production factor imports. The same necessarily goes for double tax relief systems in international tax systems that are based on these neutrality concepts. An alternative a concept is developed that is referred to as 'production factor neutrality'. This neutrality concept proves to promote tax neutrality of both inbound and outbound movements of the production factors of capital, labor and enterprise.

The point made is that 'internal equity' and 'internal production factor neutrality' ask for the levy of a worldwide taxation on the business proceeds of firms that have a business connection, nexus, in a taxing state. To acknowledge the single tax principle, this worldwide taxation should be combined with an equitable and neutral form of double tax relief. For that purpose, the mechanism adhered to is the double tax relief methodology as is currently available to tax paying individuals residing in the Netherlands: the 'credit for domestic tax attributable to foreign income'. This produces a model in which all countries involved pay tax on their share of the worldwide income to which they are entitled; 'taxing the fraction'.

This chapter concludes by illustrating the non-distortive effects of the advocated fractional approach by means of numerical examples under a progressive tax rate structure, cross-border losses, intra-firm modes of transfers and currency exchange rate fluctuations. A thought experiment is engaged into for this purpose, which assumes that the model is utilized at both sides of the tax border. That is to analytically cancel out the effects of the tax disparities that are dealt with as an analytically separate matter in Chapters 4 through 6. The approach taken conceptually corresponds to the 'internal consistency test' in US constitutional law.[173] This chapter is wrapped-up with an analytical linking of the advocated approach with that of the Court of Justice in its case law in direct tax matters.

3.2 What standard should be required for an international tax system to be 'fair'?

3.2.1 General remarks

The sub-question of how to eliminate the unilaterally imposed obstacles in the international tax system of a nation state is actually preceded by another one: what standard has to be fulfilled for an international tax system to qualify as internally 'fair'? How can one achieve fairness within a state's international tax system with respect to the corporate taxation of multinationals that are active within their territories? The answer to this question would provide the key to the development of a concept of fairness within an international tax system, i.e., an international tax system without obstacles.

Inspiration for an answer to this question can again be found in international tax theory.[174] Leads can also be found in the case law of the Court of Justice interpreting the European

[173] See e.g., United States Supreme Court, *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983), and *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995). See for some analysis Ruth Mason, 'Made in America for European Tax: The Internal Consistency Test', 49 *Boston College Law Review* 1277 (2008), at 1283, and Walter Hellerstein, 'Is Internal Consistency Dead?: Reflections on an Evolving Commerce Clause Restraint on State Taxation', 61 *Tax Law Review* 1 (2007-2008), at 1. See also the prequel to this article, Walter Hellerstein, 'Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation', 87 *Michigan Law Review* 139 (1988-1989).

[174] See for a comparison Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Parts I, II & III)', 8/9 *Intertax* 216 (1988), at 216-228, 10 *Intertax* 310 (1988), at 310-320 and 11 *Intertax* 393 (1988), at 393-402, Nancy Kaufman, 'Fairness and the Taxation of International Income', 29 *Law and Policy in International Business* 145 (1998), at 145-203, Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapter 1 and Eric C.C.M. Kemmeren, 'Source of income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach', 60 *Bulletin for International Taxation* 430 (2006), at 430-452.

Union's fundamental freedoms in the field of direct taxation. With every preliminary question on the fundamental freedoms in this area, the Court of Justice sees itself confronted with the same question: *'Does European Union Member State X impose an obstacle (discrimination / restriction) when applying tax measure Y; yes or no?'*[175]

One may therefore expect that the Court of Justice, when answering this question, would analytically adopt the same reasoning each and every time for this purpose. That is because the court is called upon to give a preliminary ruling on analytically the same question in each and every occasion. Assuming the court's reasoning is analytically sound, an analysis of its case law should enable a deduction of the underlying rules directing its rulings. Much like the solutions of mathematical problems enable the deduction of the underlying mathematical rules directing these solutions. One could similarly infer the underlying standards adopted by the Court of Justice from its case law. These standards would then provide the building blocks for an international tax system without obstacles. This provides all the reason to explore the Court's case law to somewhat deduce its underlying reasoning therefrom. Unfortunately, as will be shown the Court of Justice's reasoning however is not consistent.

3.2.2 Fairness within the system; tax competence at state level, disparities as a given

The exploration of the notion of fairness within an international tax system in this chapter requires that the following analytical assumption is made. As said, for the purpose of pursuing the analysis, the current reality of the competences of the nation states to levy direct taxes is taken as a given.

Logic prescribes that the necessary consequences of the sovereignty supposition should be taken as a given also. This for instance holds regarding disparities, or mismatches. As discussed in Chapter 1, disparities are market distortions that occur due to mutual divergences between the international tax systems of states. Disparities are the consequence of non-coordination in the international tax regime. Examples include the market distortions that result from the mutual divergences in the taxable entity, base, and rate, as well as mutual divergences in the application of the international tax principles of nationality, source and residence. Disparities result in different tax burdens on the proceeds from cross-border economic activities in comparison with proceeds from purely domestic economic activities. This affects the geographic distribution of production factors. The presence of disparities or mismatches is widely considered problematic.[176]

It also follows from this that disparities can only be considered problematic if one is willing to encroach upon the sovereignty supposition, as the disparities in the international tax regime may only be removed through tax-coordination; and tax-coordination necessarily requires the limitation of nation state competences in the field of direct taxation.

However, even though disparities are typically considered problematic, the requirement for resolving it, i.e., a transfer of autonomy is generally considered unacceptable. Illustrative in this regard is the trend in the European Union where European Union Member States on the one hand express the objective to harmonize their tax and other legislation, which requires a transfer of sovereignty to the European Union, while the same Member States on the other hand seek to maintain their sovereign competence to levy direct taxes.

[175] See for a comparison Frans Vanistendael, 'Denkavit Internationaal: The Balance between Fiscal Sovereignty and the Fundamental Freedoms?', **47** *European Taxation* 210 (2007), at 210-213.
[176] See OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing, 12 February 2013, OECD, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, 19 July 2013, OECD, *Hybrid mismatch arrangements; Tax policy and compliance issues*, OECD, Paris, 2012, European Commission, Staff working paper, *The internal market: factual examples of double non-taxation cases,* Consultation document*,* Brussels, TAXUD D1 D(2012).

3.2.3 Equity within the international tax system of a state

3.2.3.1 The benefits principle and the ability to pay principle within the international tax system of a state

In Chapter 2 it is noted that the notion of equity is a moral concept that is founded on the principle of equality. As said, everyone in an economic relationship with a taxing state has the moral obligation to contribute to the financing of the public goods provided from which one benefits – i.e., the benefits principle – in accordance with one's means – i.e., the ability to pay principle. A further cornerstone property of each international tax system of a state, as said, is the single tax principle.[177] It is both unfair and inefficient to tax the same income more than once or not at all.[178] Under the assumption of a nation state's fiscal sovereignty, a corporate taxpayer's business profits should be taxed once, by one state only, as close to its source as possible.

From this it may be deduced that the notion of equity within a tax system requires that the level of tax should be determined by some rough reference to the public goods provided by the taxing state. That is to appreciate the benefits principle.[179] Corporate taxpayers should contribute to the financing of public goods provided by a nation state irrespective of their place of residence, as soon as their economic presence within that state exceeds a certain minimum threshold – a business connection; 'nexus'.[180] The tax should be levied as close as possible to its source, i.e., where the multinational conducts its business activities.[181] Examples of tax jurisdiction thresholds currently applied by states are the concepts of permanent establishment and the place of effective management.[182] The question of whether these thresholds operate adequately, as said, is addressed in Chapter 6.

3.2.3.2 Equity requires that a tax-border crossing has no effect on the overall tax burden imposed by a state

When it comes to the determination of the corporate tax burden in the taxing state where the relevant multinational firm has some nexus, it may also be deduced from the equity notion that it should be immaterial where the corporate taxpayer has it geographical place of residence. It should also be immaterial whether the firm derived its business proceeds geographically; from sources solely within that state or from sources geographically dispersed across a multitude of states. The firm's worldwide corporate earnings should be taken into account in this respect. That is to appreciate the ability to pay principle.

Equity further requires countries to give the same tax treatment to taxpayers engaging into tax-border passages as those taxpayers that do not and only operate within that country's territories. The tax border crossing should be immaterial in the determination of the tax burden imposed on the taxpayer. For example, the business proceeds that corporate taxpayer 'Shoe Sales Company' mentioned in the previous chapter derives from its shoe selling business should be taxed equally irrespective of whether the firm resides locally or

[177] See for a comparison Reuven S. Avi-Yonah, 'Tax Competition, Tax Arbitrage and the International Tax Regime', 61 *Bulletin for International Taxation* 130 (2007), at 131. See also Reuven S. Avi-Yonah, *International Tax as International Law; An Analysis of the International Tax Regime* (2007), at Chapters 1 and 10 and Klaus Vogel, '"State of Residence" may as well be "State of Source" – There is No Contradiction', 59 *Bulletin for International Taxation* 420 (2005), at 420-423.

[178] See Reuven S. Avi-Yonah, 'Tax Competition, Tax Arbitrage and the International Tax Regime', 61 *Bulletin for International Taxation* 130 (2007), at 131.

[179] Although the relationship between thee taxes paid and the public goods received cannot be measured, it does not follow from this that such a relationship is absent.

[180] See Reuven S. Avi-Yonah, 'Tax Competition, Tax Arbitrage and the International Tax Regime', 61 *Bulletin for International Taxation* 130 (2007), at 131, and Klaus Vogel, '"State of Residence" may as well be "State of Source" – There is No Contradiction', 59 *Bulletin for International Taxation* 420 (2005), at 420-423.

[181] See for a comparison Richard J. Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World', 2 *World Tax Journal* 291 (2010), at 310.

[182] Also Vann recognizes the corporate residence rule as *"at bottom a sourcing rule like the PE rule…"* See Richard J. Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World', 2 *World Tax Journal* 291 (2010), at 293-294.

abroad for corporate tax purposes. Moreover, the tax burden imposed on Shoe Sales Company by the relevant taxing state should be equal regardless of whether the firm operates a shoe store only around the corner or abroad as well. Not only its tax place of residence, but also the question as to whether it derives its proceeds from sources within a single tax jurisdiction or across various tax jurisdictions should be immaterial in determining the effective tax burden imposed by the taxing jurisdiction involved. That is because both the ability to pay principle and the benefits principle should be simultaneously respected.

Would it be equitable to subject a firm to a different tax burden depending on the question where the taxpayer involved has geographically located its place of tax residence? Or whether it decided to geographically derive its business income from sources within a single state or spread across various states? In an increasingly borderless global market environment, that is? Would it be fair to subject taxpayers to diverging tax burdens due to the mere business decision to operate in a cross-border environment, rather than in a purely domestic environment? My answer would be negative as I do not recognize the change in circumstances of passing a tax-border as a relevant parameter to determine the corporate tax burden on proceeds from domestic sources. Tax borders are constructs, legal lines drawn by man. Both the 'overtaxation' and 'undertaxation' of cross-border business activities in comparison with non-cross-border (domestic) business activities should essentially be considered unfair.[183]

3.2.3.3 Market equality principle in European Union law requires the same

European Union law requires that cross-border economic activity is treated on a par with domestic economic activity for tax purposes

The notions of equity as explained in the above paragraph may be recognized within the context of the European Union as well. Where the Treaty on Functioning of the European Union applies, the fundamental freedoms – as interpreted and explained by the Court of Justice – recognize the equality principle in an equivalent manner.

In general, the Court of Justice's approach is fairly distinct. Provided that the Treaty on Functioning of the European Union applies, free movement means that all economic operators may rely on the application of the same national tax rules for participation in the domestic markets of the respective European Union Member States, irrespective of their place of residence – the 'market equality principle'.[184] In the event that a Member State disregards the principle of market equality by taxing economic operators differently on the basis of their place of residence, this Member State imposes an obstacle – i.e., it discriminates.

The obstacles that the European Union Member States have created in their international tax systems distort the functioning of the internal market. Economic operators often see themselves hindered when moving between the domestic markets of the respective European Union Member States. The crossing of a tax-border by an economic operator within the borderless internal market often results in a tax treatment that differs from the treatment in a domestic scenario. Moving across tax jurisdictions within the internal market often has effects in terms of the tax burdens imposed by the individual European Member States. As tax border passages should not have an effect in an internal market without internal frontiers in terms of the tax burden imposed by a Member State, obstacles are incompatible with the fundamental freedoms.

[183] See Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 827. This, in itself obvious consideration, is not followed in international taxation. Illustrative is the substantial flow of Court of Justice case law on the fundamental freedoms in the field of direct taxation.
[184] Cf. Frans Vanistendael, 'In Defense of the European Court of Justice', 62 *Bulletin for International Taxation* 90 (2008), at 90-98. See also Frans Vanistendael (ed.), *EU Freedoms and Taxation* (2004), at 106. The same may be true for residents of non-European Union Member States in the event that the European Union has concluded an association agreement with that state containing provisions (having direct effect) dealing with free movements of goods, services, persons and capital.

As said, the issue is not limited conceptually to the tax systems of the European Union Member States. The unilaterally created tax inequities in country tax systems faced by economic operators and their investments upon crossing a tax border do not only distort the functioning of the internal market, but also distort the functioning of the emerging global market. As said, there is no conceptual difference between the internal market and the global market.

Tax parity of resident taxpayers and non-resident taxpayers

The sizeable flow of rulings of the Court of Justice in the field of direct taxation neatly illustrates the inequities and inefficiencies in the international tax systems of the European Union Member States. The fundamental freedoms and the case law of the Court of Justice interpreting the operation of these freedoms further provides lines of reasoning on how to dissolve these obstacles. This makes it worthwhile to look at the case law worthy to look into.

According to various rulings of the Court of Justice, residents and non-residents are in a comparable position when a Member State exerts its fiscal sovereignty over them.[185] Resident and non-resident taxpayers accordingly find themselves in equal circumstances on the mere basis that the taxing state exercises its taxing powers over both of them.

For tax purposes, this means that a non-resident taxpayer deserves the same tax treatment as a resident by a European Union Member State as soon as this European Union Member State decides to tax this non-resident. Member States are typically considered to have tax jurisdiction if and to the extent that a non-resident conducts business activities through a branch – i.e., a permanent establishment – situated in that state. Tax jurisdiction is typically also exercised when a non-resident is subject to a source tax, for instance on outward bound dividends, interests or royalty payments.

The economic operator's place of residence should be of no relevance whatsoever when it comes to determining its tax burden in a European Union Member State. However, this notion does not correspond to the residence principle as employed in the OECD and the UN Model Conventions on income and capital – establishing limited tax liability for non-resident taxpayers on the one hand and unlimited tax liability for resident taxpayers in combination with double tax relief on the other hand.[186]

Tax parity requirement does not apply unimpaired – Court of Justice

However, under primary European Union law in the field of direct taxation, as it currently stands, the principle of equality unfortunately does not apply unimpaired. For example, the concept of 'most favored nation treatment' as an expression of the equality principle is not acknowledged by the Court of Justice. European Union law as it currently stands seems to allow that residents of other Member States are treated differently compared to residents of third Member States under their double tax conventions, in my view for indistinct – though

[185] Cf. Court of Justice, cases C-527/06 (*Renneberg*), C-170/05 (*Denkavit Internationaal*), C-379/05 (*Amurta*), as well as Court of Justice, cases C-303/07 (*Aberdeen*) and C-374/04 (Test *Claimants in Class IV of the ACT Group Litigation*). Contra Court of Justice, cases C-279/93 (*Schumacker*) and C-385/00 (*De Groot*). An exception is made in these two latter cases with respect to taxpayers/individuals incurring personally related (tax deductible) expenses. When the tax treatment of personal allowances is the subject of debate, the Court of Justice, in my view for indistinct reasons, all of a sudden adopts an alternate reasoning than its typical approach on the basis of which resident and non-resident taxpayers are in comparable circumstances as soon as an European Union Member State exercises its taxing powers on both of them. In the event of personally related expenses, non-resident taxpayers are only in a comparable position with resident taxpayers when these non-resident taxpayers earn 90% or more of their income in the source state; the 90%-threshold. See for comparison, B.J.M Terra et al, *European Tax Law* (2012), at 26: *"Thus, the Court (unfortunately, in our view) accepted that residents and nonresidents are not, as a rule, comparable for income taxation purposes (case C-279/93 (Schumacker), in order to allow source taxation for nonresidents and worldwide taxation for residents", and at 525: "But: Residents and Nonresidents Are Not in a Different Position".* See also Peter J. Wattel, 'Red Herrings in Direct tax Cases before the ECJ', 31 *Legal Issues of Economic Integration* 81 (2004, No. 2), at 81-95.

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

politically understandable – reasons.[187] For example, in the *D. case*, the Court of Justice allowed the Netherlands to tax-treat non-resident taxpayers residing in Germany differently from non-resident taxpayers residing in Belgium and taxpayers residing in the Netherlands. Taxpayers that resided in Germany were refused the allowance for wealth tax whereas those that resided in Belgium and the Netherlands were entitled to the allowance for wealth tax.[188]

Moreover, the Court of Justice unfortunately seems to condone that Member States reversely discriminate against their taxpayers who are nationals or residents compared to taxpayers who are non-nationals/residents or non-nationals/non-residents. The Court allows the Member States to tax-treat the 'foreigner'. An example of a reversed discrimination sanctioned by the Court of Justice is the case of the *Heirs of M.E.A. van Hilten-van der Heijden*.[189] The case involved Dutch inheritance tax, which provides that the estate of a Dutch national who dies within ten years after his or her emigration from the Netherlands to a foreign country is taxed as if that national had continued to reside within the Netherlands. A credit for foreign estate tax is provided for double tax relief purposes. The estates of emigrated non-nationals, however, are not subject to the ten year rule – a reverse discrimination accordingly. The Court of Justice observed that such a difference in tax treatment for tax allocation purposes cannot be regarded as discrimination in breach of the fundamental freedoms. The Court accordingly seems to allow the Member States to discriminate against its own nationals, at least to a certain extent.

In addition, in my view for indistinct reasons also, purely domestic scenarios fall outside the scope of the fundamental freedoms.[190] Economic operators in purely domestic situations who receive a less favorable tax treatment than those that operate across a tax border of a Member State have to invoke the equality principle as applied in the domestic legal order of the respective Member State, or the human rights conventions to which the Member State is a party. An example of this can be found in the *Flemish social security insurance case* dealing with the access to Flemish social security insurances of workers in Flanders, Belgium.[191] Under the Flemish social security insurance under scrutiny in this Belgian case, Walloons that worked in Flanders were treated differently from Flemish and other European Union citizens working in Flanders, despite the fact that the circumstances were equal for all of them – all citizens conducted economic activities within the territories of the European Union, Flanders in this case. The Court of Justice, however, allowed Belgium to treat these citizens differently as it considered the unfavorable treatment of the Walloons relative to the Flemish a purely domestic situation. The Walloons had to invoke the equality principle laid down in the Belgian Constitution.

This being said about the *Flemish social security insurance case*, however, the Belgian *Zambrano case* casts some doubt on these remarks.[192] In *Zambrano*, the Court of Justice considered a purely internal scenario to fall within the scope of application of the Treaty on Functioning of the European Union. The Court considered European Union law, i.e., the right

[187] See on the political rationale underlying case C-376/03 (*D.*), Peter Harris et al, *International Commercial Tax* (2010), at 403-407. Harris and Oliver observe that the Court of Justice *"was of the opinion that the European Union apparently was not quite ready for the full-blown effects of an internal market".* They fairly conclude that the indirect consequence of *D.* is that a source state may discriminate against European Union Member State investors in their double tax conventions.

[188] See Court of Justice, cases C-376/03 (D.) and C-298/05 (*Columbus*). But Cf. Court of Justice, case C-196/04 (*Cadbury* Shweppes) as well as case C-466-469/98, 471-472/98, 475/98 and 477/98, (*Open Skies cases*). Cf. H.J. Noordenbos, 'Unilaterale begunstiging strijdig met het EG-Verdrag', 138 *Weekblad Fiscaal Recht* 79 (2009), who argues that most favored nation treatment under the domestic laws of the European Member States is incompatible with the fundamental freedoms. The question as to the (in)compatibility with most favored nation treatment on the basis of domestic law is currently pending before the Court of Justice; case C-512/13 (*Sopora*).

[189] See Court of Justice, case C-513/03 (*Heirs of M.E.A. van Hilten-van der Heijden*).

[190] The reasons for this are in my view indistinct. That is as movements of capital and labor within a European Union Member State – i.e. purely domestic activities – are movements within the internal market as well. Economic operations within a Member State are economic operations within the internal market. I fail to understand why domestic scenarios would need to fall outside the scope of application of the Treaty on Functioning of the European Union. I fail to appreciate a conceptual difference between a national market and an internal market without internal frontiers.

[191] See Court of Justice, case C-212/06 (*Flemish social security insurance*). Notably, Advocate-General Sharpston pleaded for extending the scope of the Treaty on Functioning of the European Union to purely domestic scenarios by pointing at the concept of the internal market without internal frontiers.

[192] See Court of Justice, case C-34/09 (*Zambrano*).

of residence within European Union territory for European Union nationals, to apply to a minor child, a Belgian national, irrespective of its previous exercise of its right of free movement. So in this case European Union law seemed to apply also in purely domestic scenarios. Or is this only the case in European social security matters (except for social security insurances) and not in the area of direct taxation? We do not know. This renders matters legally indistinct in this respect.

The application of European Union law also in purely domestic scenarios would make sense. That is because also a purely domestic activity within a European Union Member State is an activity undertaken within the European Union's internal market without internal frontiers. Why should European Union law not apply to all activities within European Union territory? Purely domestic activities are activities within the internal market without internal frontiers as well. Why would a cross-border element have to be present to apply the Treaty on Functioning of the European Union in an area without internal frontiers? So the court's case law has left a gap between how the freedoms ought to apply and the manner in which the court interprets and applies these freedoms; a difference between 'is' – i.e., how the law applies today – and 'ought' – i.e., how the law should apply – accordingly.

Leaping forward towards market equality; Renneberg

This being said, nevertheless the Court of Justice has taken a big leap forward towards the recognition of the 'European Union resident' for tax purposes in the *Renneberg* case.[193] In *Renneberg*, the Court of Justice recognizes an obstacle in the tax treatment in the Netherlands of non-resident taxpayers deriving income from both foreign sources and domestic sources. The tax treatment of non-resident taxpayers differed from that of Dutch resident taxpayers deriving income from both foreign and domestic sources.

The Netherlands allows its resident taxpayers individuals to include negative income items from foreign sources in the domestic, i.e., the Dutch source, tax base being the worldwide income. With respect to the foreign income of resident taxpayers, the Netherlands provides double tax relief on the basis of the so-called 'tax exemption with progression' method. This method basically functions as a credit for the Dutch income tax that is attributable to the foreign source income items. Please note that the double tax relief method is explained in detail in sections 4 and 5 of this chapter as the method in itself operates equitable and economically efficient.

Conversely, the Netherlands does not allow non-resident taxpayers to include negative income items from foreign sources in the Dutch tax base. The foreign income of non-resident taxpayers is 'exempt' from Dutch tax; the territorial taxation of non-resident taxpayers. By doing this the Netherlands effectively provides 'double tax relief' to non-resident taxpayers through a 'base exemption'. Regardless of the terms used, conceptually it is a base exemption in terms of its effects.

Consequently, non-resident taxpayers who are subject to taxation at source and who receive 'double tax relief' through a 'base exemption' are treated differently and, in the *Renneberg* case less favorably, relative to resident taxpayers who are subject to tax on their worldwide taxation and who receive double tax relief through the Dutch-style tax exemption. The difference in tax treatment is based *solely* on the taxpayer's place of residence for tax purposes. In the Renneberg case, the Court of Justice observed that the Netherlands, by doing so, imposed an obstacle, i.e., an indirect discrimination that could not be justified by

[193] See Court of Justice, case C-527/06 (*Renneberg*). Contra Court of Justice, case C-250/95 (*Futura*).

overriding reasons in the general interest.[194-195] Consequently, the Netherlands was required to eliminate this obstacle from the Dutch international tax system.[196]

The *Renneberg* case has far-reaching consequences if the reasoning of the Court of Justice were to be conceptually rated at its true value and the potential effects were to be assessed in full. In this respect it should be noted that equal tax treatment in the manner required by the Court of Justice in *Renneberg* can only be achieved by fully removing the current difference in tax treatment based on the taxpayer's residence. Tax parity would only be achieved if the taxpayer's place of tax residence would be completely removed from the tax system as a relevant factor in determining the tax burden.

It follows from logic reasoning that the parity in taxation of resident and non-resident taxpayers can only be achieved at the end of the day by adopting worldwide taxation for both residents and non-resident taxpayers once the Netherlands exercises its sovereign taxing powers. As will be demonstrated in the following sections, double tax relief would need to be granted for a taxpayer's foreign source income items by applying the Dutch-style tax exemption mechanism. Territorial taxation of both residents and non-residents would prove analytically insufficient, for it distorts outbound movements of production factors.

Tax-parity under Renneberg *versus approaches in international taxation*

This observation on the requirement of tax-parity of resident taxpayers and non-resident taxpayers is not only relevant for the Dutch international tax system. In basically all international tax systems worldwide the tax treatment of resident taxpayers differs from that of non-resident taxpayers. Resident taxpayers are typically subject to a worldwide taxation with a reduction for double tax relief in respect of a taxpayer's foreign income items. Non-resident taxpayers on the other hand are subject to a territorial taxation; foreign source income is disregarded which effectively translates into a base exemption for tax purposes. Notably, as will be demonstrated hereunder in section 2.4.4 of this chapter, the alternative, i.e., the adoption of a strict territorial system in respect of both non-resident and resident taxpayers would not provide a solution. The same is true for a worldwide system with a base exemption for foreign income. That is, because territorial systems also do not promote equal tax treatment of domestic and cross-border economic activity in the end; they hinder outbound investment.[197]

Indeed, the approach taken by the Court of Justice in *Renneberg* does not correspond to the typical different tax treatment of resident and non-resident taxpayers in the current international tax regime – i.e. worldwide taxation in combination with double tax relief for foreign income versus territorial taxation. And indeed, the tax differential between the resident and the non-resident taxpayer is even explicitly sanctioned by the OECD in its commentary on its Model Convention on Income and Capital.[198] The double tax convention networks of essentially are essentially built on a differential in treatment between resident and non-

[194] Unfortunately, in its ruling the Court of Justice took the 'Schumacker route' (personal allowances) rather than a *Marks & Spencer II* approach (territoriality and anti-abuse). The court observed the tax allowance for debt financed personal dwellings to constitute a personal allowance, rather than a negative income item from the commercialization of real estate – which it economically is.
[195] But see D.M. Weber, annotation Vakstudie Highlights & Insights 2008/2.4. Weber conceptually recognizes a disparity in Court of Justice, case C-527/06 (*Renneberg*), and bases this on Court of Justice, case C-250/95 (*Futura*).
[196] Notably, the Netherlands did this by introducing the possibility for non-resident taxpayer individuals deriving income from both Dutch and foreign sources to opt for a tax-treatment akin to residence taxpayer tax treatment. That is to enable them, for instance, to offset negative income from foreign sources against positive income from domestic sources under the application of a recapture mechanism to secure single taxation. The treatment is similar to resident taxpayers however full tax-parity has not been made available – triggering non-discrimination issues. As of 1 January 2015, the system is changed. As of that date, non-resident taxpayers deriving 90% or more of their income from Dutch sources will be subject to a tax-treatment akin to residence taxpayer tax treatment. Again, tax-parity is nog created. Already today, the amendments have attracted discussion in the Dutch tax literature as to its alleged non-discriminatory tax treatment. See F.P.G. Pötgens, 'Van een kiezende naar een kwalificerende buitenlandse belastingplichtige', 142 *Weekblad Fiscaal Recht* 1348 (2013), at 1348-1361.
[197] See 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.
[198] See OECD, Commentary on Article 24 of the OECD Model Tax Convention on Income and on Capital, OECD, Paris, 2010, par. 7.

resident taxpayers. A typical double tax convention for instance only applies to taxpayers that are resident of one of the contracting states. Non-resident taxpayers of such a contracting state that reside in a third-country for tax purposes are generally ineligible for treaty benefits. This triggers obvious non-discrimination issues as this difference in tax treatment is essentially discriminatory.[199] The OECD thinks otherwise. In the commentary on its model convention, the OECD is of the opinion that the taxpayer's place of residence constitutes a difference in circumstances justifying a different tax treatment – i.e., save for the source state in some specific scenarios explicitly addressed in the non-discrimination provision in Article 24 OECD Model Convention on Income and Capital. The OECD's approval, however, does not mean that things are all right conceptually.

It has been observed in the literature that the ruling of the Court of Justice in *Renneberg* forms a threat to the double tax convention networks of countries as the ruling is not in line with international taxation concepts.[200] Because the *Renneberg* ruling deviates from the approaches in traditional international tax law the ruling is generally considered flawed: '*Renneberg* differs from international taxation and therefore *Renneberg* is wrong'.[201] However, it may equivalently be argued that the double tax convention networks of countries and its concepts used are a threat to the equitable tax treatment of resident taxpayers and non-resident taxpayers which has been recognized by the Court of Justice in *Renneberg*. 'International taxation differs from *Renneberg* and therefore international taxation is wrong.'

In my view, the question of which of the approaches normatively trumps the other at this point requires an assessment of the underlying concept of equity. Merely pointing at the difference in approaches is insufficient to normatively arrive at the conclusion as to which of the two should prevail. Neither the Court of Justice's observations in *Renneberg*, nor the approach taken in traditional international taxation is the test; it is the equality principle that constitutes the benchmark. *Renneberg* and the international tax approach are the objects of the test. As the extensive calculations in the upcoming sections shall demonstrate, the difference in the tax treatment of the resident and the non-resident taxpayer is essentially discriminatory. Let us proceed.

3.2.4 Tax neutrality within the international tax system of a state

3.2.4.1 Economic efficiency within the international tax system of a state

As mentioned in Chapter 2, the notion of economic efficiency is based on the presumption that the productivity of income is the highest, and with that also the fairest, when production factors are distributed on the basis of market mechanisms without, or at least with as little as possible, public interference. Taxation should not affect business decisions, neither in a positive nor in a negative manner. The tax parity should hold irrespective of the direction of the movement of capital, labor, or enterprise – tax neutrality.

3.2.4.2 Tax neutrality requires that a tax-border crossing has no effect on the overall tax burden imposed by a state

Tax neutrality within an international tax system accordingly requires that where a nation state exercises its sovereign taxing powers, the tax burden it imposes on business income earned from domestic sources should be the same regardless of whether the business activities involved are performed solely within the territories of the taxing state or performed or directed across the territories of various states. In terms of domestic tax burdens imposed it should be immaterial whether the business activities are performed in a purely domestic context or in a cross-border economic environment. In addition, it should be immaterial where a taxable economic operator has established its place of residence.

[199] Cf. Court of Justice, case C-307/97 (*Saint-Gobain*).
[200] See for a comparison E.C.C.M. Kemmeren, 'Renneberg Endangers the Double Tax Convention System or Can a Second Round Bring Recovery?', 18 *EC Tax Review* 4 (2009), at 4-15.
[201] *Ibidem*.

Let us suppose that the tax burden in a particular state differs depending on the economic operator's place of residence or whether or not it performs its business activities in a cross-border context. Take our taxpayer Taxi Company, for example. Although Taxi Company operates its taxi service business enterprise domestically, across the street, as mentioned in Chapter 2 – it resides abroad. Or let us assume that our taxpayer Taxi Company – residing within the territories of the taxing state operates two taxi service businesses: one domestically across the street and one across the border. In the event that Taxi Company's local corporate tax burden would be different depending on its place of tax residence or the circumstance of whether or not it operates its taxi business enterprise both across the street and abroad, this would influence the entrepreneurial decision on keeping things local or crossing the tax border. Indeed, Taxi Company's management would think twice before taking such a business decision.

Differentials in tax burdens that arise in consequence of exercising the decision to economically passage the tax border obviously affects the decision as to extend business across the borders of a taxing jurisdiction's territories. One may for instance think of the following scenarios. A state for instance may subject hidden reserves to immediate corporate taxation upon corporate emigrations or outward bound cross-border intra-firm capital asset transfers while equivalent movements within that state's territories do not attract such a levy – exit taxes levied upon outward bound tax border crossings.[202] One may also think of disallowing cross-border aggregation of business profits and losses realized while such an aggregation is available to the extent that the business operations are carried on within that state's territories – cross-border loss offset.[203]

Tax effects upon tax border crossings are inconsistent with today's economic reality of an increasingly borderless global marketplace. Taxation would obviously also affect Taxi Company's decision as to stay at home or to take up business activities across the tax border. For instance the impossibility to offset foreign losses against domestic profits, while such an offset is available in a purely domestic scenario creates a bias towards investment in the taxing jurisdiction in which the taxpayer already derives taxable profits.[204]

To the extent that the international tax system of a state unilaterally affects business decisions, it distorts the proper functioning of the globalizing economy. Under the notion of neutrality within the international tax system of a state, such a differential tax treatment upon the crossing of a tax border of an economic operator or its economic activity is undesirable.

3.2.4.3 Market neutrality principle in European Union law requires the same

Also European Union law requires that cross-border economic activities are taxed in the same way as domestic economic activities

The notions of neutrality as set forth in the above paragraph may be recognized within the context of the European Union as well. Where the Treaty on Functioning of the European Union applies the fundamental freedoms as interpreted and explained by the Court of Justice the neutrality principle is basically recognized in an equivalent manner.

Again, in general, the Court of Justice's approach is fairly distinct. From the Court of Justice's case law it can be derived that tax neutrality constitutes a cornerstone principle of European Union law. Provided that the Treaty on Functioning of the European Union applies, the fundamental freedoms guarantee that economic operators can move their business activities between the respective domestic markets of the European Union Member States under the

[202] See, e.g., Court of Justice, case C-371/10 (*National Grid Indus*).
[203] See, e.g., Court of Justice, cases C-250/95 (*Futura*), C-168/01 (*Bosal*), C-446/03 (*Marks & Spencer II*), C-414/06 (*Lidl*), C-123/11 (*A Oy*), C-322/11 (*K.*), and C-157/07 (*Krankenheim*). See also EFTA Court, case E-7/07 (*Seabrokers*).
[204] 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. See also Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55.

free movements rights – the 'market access' or 'market neutrality principle'.[205] In the event that a Member State infringes on the market neutrality principle by taxing economic operators differently as soon as they move their businesses between the respective domestic markets of the European Union Member States, these Member States unilaterally impose an obstacle, i.e., a restriction. In such a case the tax treatment differs, depending on whether the respective economic operator performs its business activities in an intra-European Union cross-border or in an intra-European Union domestic context.

The obstacles that the European Union Member States have created in their international tax systems distort the functioning of the internal market. Economic operators often see themselves hindered when they direct their investments across the domestic markets of the respective Member States. That is as the crossing of a tax border within the internal market without internal frontiers often produces a differential in tax treatment relative to the domestic scenario. The shifting of corporate investment between tax jurisdictions within the internal market often has effects in terms of the tax burdens imposed by the individual European Member States. As tax border passages should make no difference in the internal market, restrictions are incompatible with the fundamental freedoms.

Again, the issue is not limited conceptually to the tax systems of the Member States of the European Union. The unilaterally created tax inefficiencies in country tax systems upon tax border crossings of economic operators and their investments do not only distort the functioning of the internal market. They also distort the functioning of the globalizing market. As said there is no conceptual difference really between the internal market and the global market.

Tax parity of returns from domestic investment and returns from cross-border investment

Again, the rulings of the Court of Justice in the field of direct taxation provide ample illustrations of the restrictions in the international tax systems of the European Union Member States.

According to various rulings of the Court of Justice, proceeds from intra-European Union cross-border investment and proceeds from intra-European Union domestic investment are comparable, as soon as a Member State exercises its sovereign taxing power over these activities.[206] It does so by reference to the presence of a group company, a permanent establishment, or through levying a tax at source.

For tax purposes this means that a taxpayer, who directs its investment across a tax border, deserves to be treated neutrally for tax purposes vis-à-vis a taxpayer that directs its investment solely within the territories of the taxing Member State. Each business activity performed within the territories of a Member State and taxed by that state is comparable under European Union law and, hence, deserves the same tax treatment. Consequently, there should be no difference in the tax burden imposed by that state regardless of whether the business activities are performed solely within that Member State or spread across various Member States.

This entails that the geographic location, the direction and the extent of the economic operator's investments should be of no relevance when it comes to determining the tax burden on investment proceeds in a European Union Member State. It is noted that this does not correspond to the concepts of limited tax liability and strict territorial taxation. These

[205] See Frans Vanistendael, 'In Defense of the European Court of Justice', 62 *Bulletin for International Taxation* 90 (2008), as well as Frans Vanistendael (ed.), *EU Freedoms and Taxation* (2004), at 107. The same may be true for residents of non-European Union Member States in the event that the European Union has concluded an association agreement with that state containing provisions (with direct effect) dealing with free movements of goods, services, persons and capital.

[206] Cf. Court of Justice, cases C-527/06 (*Renneberg*), C-170/05 (*Denkavit Internationaal*), C-379/05 (*Amurta*), C-303/07 (*Aberdeen*), C-374/04 (*Test Claimants in Class IV of the ACT Group Litigation*), C-397/98, C-410/98 (*Metallgesellschaft / Hoechst*), C-446/04 (*FII*), C-446/03 (*Marks & Spencer II*), C-293/06 (*Deutsche Shell*), C-231/05 (*Oy AA*) and C-414/06 (*Lidl*).

concepts are widely employed in the international tax regime with regards to non-resident taxpayers. Also the OECD and the UN Model Conventions on income and capital accept the limited tax liability of non-resident taxpayers.[207] Under double tax treaties, for instance, the source state is entitled to tax non-residents only if and to the extent that these derive income from sources situated in that state. And the double tax relief mechanisms in the tax conventions are targeted to apply in the state of residence only. Some tax jurisdictions extend the approach of taxing only domestic income to both non-resident taxpayers and resident taxpayers (e.g., Hong Kong, Singapore, Panama).

Moreover, European Union law, as it currently stands also seems to acknowledge the notion of the neutrality of legal form.[208] The legal structure of a business activity seems to be irrelevant under the freedom of establishment. Established case law of the Court of Justice reveals that the Member States are sovereign in their decisions on the taxable entity and who is liable to pay tax. European Union Member States are, for example, free to decide on the transparency of a legal entity for tax purposes such a partnership, and to tax the persons behind it – the underlying partners or shareholders.[209] However, to establish tax neutrality, the Member States may not unilaterally distort the economic operator's choice of the legal form when structuring its intra-European Union business activities (i.e., if and to the extent that it is immaterial in a purely domestic).

It follows from this that the plain comparison between the intra-European Union cross-border business activity and the intra- European Union business activity is indicative in identifying an obstacle. The manner in which the firm has legally arranged its business affairs is irrelevant.[210] In an internal market without internal frontiers, the opinion may be held that this should hold true irrespective of the direction of the investment, thus with respect to both home state cases regarding outbound investments of domestic firms, and host state cases regarding inbound investments of foreign firms.[211]

[207] See for comparison E.C.C.M. Kemmeren, 'Renneberg Endangers the Double Tax Convention System or Can a Second Round Bring Recovery?', 18 *EC Tax Review* 4 (2009), at 4-15.
[208] See, e.g., Court of Justice, case C‑18/11 (*Philips Electronics*), observations 13 and 14. See for some analysis Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010), as well as Maarten F. de Wilde, 'Over de (on)verenigbaarheid van het fiscale-eenheidsregime met de vestigingsvrijheid', 138 *Weekblad Fiscaal Recht* 1546 (2009). Contra, Peter Harris et al, *International Commercial Tax* (2010), at 70 and 319, who suggest that European Union law adopts a separate entity approach.
[209] See Court of Justice, case C-298/05 (*Columbus*) and the Opinion of A-G Maduro in Court of Justice, case C-446/03 (*Marks & Spencer II*). See also Court of Justice, cases C-307/97 (*Saint Gobain*), C-311/97 (*RBS*), and 270/83 (*Commission/France*). Cf. Dutch Supreme Court, Hoge Raad, 8 February 2008, No. 43 083, published in the unofficial tax reporter Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 2008/135, where the Dutch Supreme Court applied a 'see-through' approach with respect to the subsidiaries of a Dutch resident corporate taxpayer outside European Union territory that were indirectly held through an intermediate holding company which was established within European Union territory.
[210] Cf. Court of Justice, case C-123/11 (*A Oy*). In this case, dealing with the United Kingdom's group relief regime – an intra-firm inter-entity profit pooling regime – the Court of Justice considered it irrelevant that the multinational firm involved operated its business activities in the United Kingdom through a United Kingdom tax resident group company, and a Dutch tax resident group company. The United Kingdom was still required to allow the group to offset its profits and losses from one legal entity to another, amongst others regardless of its legal organization, thereby acknowledging the neutrality of legal form under European Union law. Opinion Advocate-General Wattel, 11 September 2008, No. 08/0900, Vakstudie-Nieuws 2008/47.14.
[211] Cf. Maarten F. de Wilde, 'Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy', 38 *Intertax* 281 (2010), 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, 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, 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, Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010), Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55, as well as Erwin Nijkeuter et al, 'FII 2 and the Applicable Freedoms of Movement in Third Country Situations', 22 *EC Tax Review* 250 (2013), at 250-257.

3.2.4.4 Concepts of export neutrality and import neutrality both unilaterally distort

A closer look, however, reveals that much is unclear when it comes to discovering the tenets of the concept of tax neutrality within the international tax system of a state. In my view, neither European Union law as it currently stands nor international tax theory currently provides for a theoretically sound tax neutrality concept that is economically efficient both when business is conducted in a domestic or cross-border environment. Today's paradigmatic tax neutrality concepts in international tax law do not hold water.[212]

The traditional and generally acknowledged neutrality concepts include the concepts of capital and labor export and import neutrality.[213] The concept of export neutrality addresses the residence state, or, in European Union law terms, the home state, with respect to outward bound movements of the production factors of capital, labor and enterprise. When export neutrality is promoted taxation is linked to the place of residence or the place of effective management of the recipient of the business income or some other type of income. The basic underlying assumption of the concept is that the tax burden on the taxpayer's income in the state of its residence should be the same irrespective of the geographical location – locally or abroad – of its investment. The concept of export neutrality looks at the location of the investor, i.e., an approach that seeks tax parity in the home country of the taxable subject. The tax burden should be the same irrespective of where the income has been earned. The ability to pay principle, as an expression of the equality principle, can be recognized in this approach. Export neutrality is generally associated with worldwide taxation in the residence state in combination with an ordinary direct or indirect credit for the tax levied at any level in the source state.

The concept of import neutrality addresses the source state, or host state in European Union law terms, with respect to inward bound movements of the production factors of capital, labor and enterprise. When import neutrality is promoted taxation is linked to the place where the taxpayer's income has been produced. The basic underlying assumption of the concept of import neutrality is that the tax burden on the income produced within the source state's territory should be the same irrespective of the place of residence or the place of effective management of the recipient of the income. The concept of import neutrality looks at the location of the investment, i.e., an approach that seeks tax parity in the host state; a level playing field in the local market where the taxable object is situated. The place of the taxpayer's residence is irrelevant. The benefits principle, as an expression of the equality principle, can be recognized in this approach. Import neutrality is usually associated with a territorial, source-based, tax system. Or alternatively, with a system of worldwide taxation in the residence state combined with a base exemption for income in the source state abroad.

Vogel argues that the opposing export neutrality and import neutrality concepts cannot exist simultaneously if achieving worldwide economic efficiency is the common underlying objective.[214] Both export neutrality and import neutrality merely address one-sided movements of production factors, respectively outward bound or inward bound movements. That is, rather than the aggregate of cross-border inbound and outbound movements of the production factors of capital labor and enterprise. The concept of export neutrality disregards

[212] See for a comparison Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission, Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, who also forward that import neutrality nether export neutrality are fully optimal. See also Michael P. Devereux, 'Business taxation in a globalized World', 24 *Oxford Review of Economic Policy* 625, (2008), at 625-638, where Devereux submits some similar remarks.

[213] See for a comparison Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part II)', 10 *Intertax* 310 (1988), at 310-320 and Klaus Vogel, 'Which Method Should the European Community Adopt for the Avoidance of Double Taxation?', 56 *Bulletin for International Taxation* 4 (2002), at 4-8. See also Michael J. Graetz, 'The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies', 54 *Tax Law Review* 261 (2001), at 269-294 and Eric C.C.M. Kemmeren, 'Source of income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach', 60 *Bulletin for International Taxation* 430 (2006), at section 3. Moreover, Wolfgang Schön, 'International Tax Coordination for a Second-Best World (Part I)', 1 *World Tax Journal* 67 (2009), at 71 and 81-82, recognizes the concept of 'capital ownership neutrality'. I will leave this out of consideration.

[214] See Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part II)', 10 *Intertax* 310 (1988), at 313 and Klaus Vogel, 'Which Method Should the European Community Adopt for the Avoidance of Double Taxation?', 56 *Bulletin for International Taxation* 4 (2002), at 5.

inward bound movements of production factors. Export neutrality promoting tax systems therefore distort inbound investment. The concept of import neutrality disregards outward bound movements of production factors. Import neutrality promoting tax systems therefore distort outbound investment. This is caused by the fact that both export neutrality and import neutrality only address one dimension of equality, i.e., respectively the ability to pay principle and the benefits principle.

The concepts of export neutrality and import neutrality prove distortive when scrutinized from a perspective that is opposite to the production factor movements addressed by either the export or import neutrality concepts. That is, respectively when the concept of export neutrality is addressed from the perspective of the host state on an inward bound movement; and when the concept of import neutrality is addressed from the perspective of the home state on an outward bound production movement. It is just a matter of looking at the mirror image.

All export neutrality promoting credit systems distort inbound investment

Vogel, in my view fairly – yet contrary to the tax policy objectives generally recognized in international tax law – demonstrates that export neutrality promoting tax systems treat economic operators who perform their economic activities in both the residence state and abroad differently. That is, unequal and therefore non-tax neutral vis-à-vis economic operators who perform their economic activities solely in their residence state.[215] In the event that the residence state subjects both to the same domestic, residence state tax burden, the residence state imposes an obstacle to the economic operator investing abroad. Abroad, that is in the source state, the tax burden and the public goods granted in return are at a different level than in the residence state.

Consequently, under the concept of export neutrality, economic operators who direct their investments abroad pay tax on their foreign source income at the residence state level, but in return receive benefits from public goods provided at the different source state level. This may be in accordance with the ability to pay principle, but not in accordance with the benefits principle. By applying an export neutrality policy to resident economic operators exporting their production factors to abroad, the home state ignores the connection between the level of taxation and the public goods provided in return in the source state. A connection which indeed may be considered immeasurable, yet does not mean however that it therefore can be considered absent – and with that neglected for this purpose. Conversely, this is not the case for the economic operator who performs its activities solely in the residence state. Tax systems promoting export neutrality hence create inequitable and inefficient tax treatment of production factor imports into the host state.

The economic operator who goes abroad suffers a competitive disadvantage in the source state vis-à-vis locally active economic operators. This holds up in the event that the level of taxation in the residence state exceeds the level of taxation in the source state and the residence state taxes the excess by topping-up the effective tax rate to the home state level. This is typically achieved in tax practice via the provision of a credit for the foreign tax to be offset against the domestic tax on the taxpayer's worldwide earnings. In that case, the economic operator who exports its production factors to another country pays tax at a higher level than its local competitors, but, nevertheless, benefits from the same lower level public goods as its local peers.

The economic operator who goes abroad benefits from a competitive advantage in the source state vis-à-vis locally active economic operators when the level of taxation in the source state exceeds the level of taxation in the residence state and the residence state would

[215] See, Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part II)', 10 *Intertax* 310 (1988), at 310-320. See also Eric C.C.M. Kemmeren, 'Source of income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach', 60 *Bulletin for International Taxation* 430 (2006), at section 3. Contra, Brian J. Arnold et al, *International Tax Primer* (2002), who at 37 observe that the credit method is generally recognized to be the best method for eliminating international double taxation on tax policy grounds. I respectfully disagree.

compensate for the difference by paying out the excess foreign tax. That is, to arrive at the effective tax rate that the home state levies on investment proceeds. This may be achieved theoretically by providing a so-called full credit. In that case, the economic operator going abroad pays tax at a lower level than its local competitors, but, nevertheless, benefits from the same higher level public goods.

Both outcomes distort inward bound capital movements from the perspective of the source state relative to domestic movements. These distortions are unilaterally imposed by the residence state. Consequently, international tax systems that adhere to the concept of export neutrality create obstacles.

An example: 'Pastry Chef Company' v. 'Quiche Company'

The following example may illustrate the obstacles imposed in an international tax system that seeks to promote export neutrality. Let us suppose that corporate taxpayer 'Pastry Chef Company' resides for tax purposes in State R(esidence). Taxpayer Pastry Chef Company derives income from a business carried on abroad through a branch situated in state S(ource). The operations carried on through the branch yield a positive return at an amount of 100.

State R has an export neutrality based international tax system and subjects Pastry Chef Company's worldwide income derived through its foreign branch to a corporate income tax at a 35% tax rate, while providing for double tax relief under a credit for foreign tax mechanism. State S subjects the income derived through the branch at an income tax at a 10% rate.

Consequently, State S will subject Pastry Chef Company to tax levied at an amount of 10. State R taxes Pastry Chef Company's income to a tax of 35 but provides for relief at a 10 amount resulting in a tax payable of 25. Pastry Chef Company's overall tax burden amounts to 35 (10 + 25), i.e., an amount equal to the tax that Pastry Chef Company would have been liable to if his income would have been derived from a business carried on through a branch situated within the State R.

A tax policy officer seeking to promote export neutrality would argue that Pastry Chef Company's decision to operate abroad, as seen from the State R angle, is not distorted. However, Pastry Chef Company's local competitor, corporate taxpayer 'Quiche Company', residing in State S, operating its branch near Pastry Chef Company's across the street is subject to the 10% tax. Accordingly, each marginal currency (€) of income Quiche Company earns results in an marginal after tax profit of 0.90 while Pastry Chef Company's marginal after tax profit equals to a mere 0.65, i.e., the 'top-up effect' of a system promoting export neutrality.

If things are seen from the S State perspective, Pastry Chef Company finds itself in a disadvantageous position in comparison with its competitor Quiche Company, as he would need to derive a marginal profit amounting to 1,385 (i.e., 0.90 / 0.65) to end up in the same after tax position (i.e., 0.90) as its competitor Quiche Company (i.e., 1.385 – 0.35 * 1.385 = 0.90). Consequently, even though Pastry Chef Company receives the same lower than State R level of public benefits provided by State S – which, for the argument's sake, grosso modo corresponds to the 10% tax levied by State S – as its competitor Quiche Company does, Pastry Chef Company is subject to a nearly 40% heavier tax burden.

One may argue that Pastry Chef Company benefits from public goods provided by State R instead. However, it may be doubted whether this argument holds water as State R is not the place where Pastry Chef Company derives its income and accordingly, State R is not the place where Pastry Chef Company derives the benefits from public goods provided (rule of law, market place, infrastructure, et cetera). State S is. And it is also State S where it finds its immediate competitors. Knowing this may drive Pastry Chef Company not to engage in business activities in State S in the first place, as it would require Pastry Chef Company to apply higher than local, i.e., its competitor Quiche Company's, price levels for goods sold or services rendered. Pastry Chef Company may therefore consider an abroad investment quite

a hazardous undertaking as the reality of being subject to a heavier tax burden than its local competitors like Quiche Company could very well cause him to run out of business rapidly.

Accordingly, a tax policy officer favoring import neutrality would, in my view fairly, take an angle opposite to the tax policy officer favoring export neutrality, and argue that Pastry Chef Company's decision to operate abroad, as seen from the State S angle, i.e., the host state, is distorted unilaterally by the origin State R. State R should therefore refrain from 'topping-up' the S State tax by State R tax. This, if I understand it correctly, exactly is the point made by Vogel. Why should State R be entitled to levy such an additional tax on foreign source income derived, which is appropriately allocated to state S?[216]

Export neutrality: perhaps to counter tax abuse

Accordingly, due to the distortive features of the concept of export neutrality, the application of the ordinary credit method requires a specific justification. A justification for the ordinary credit method may be its application as a correction mechanism for the inadequacies in the international tax regime that resulted from the 1920s Compromise – which inadequacies are discussed in more detail in Chapters 4 through 6. Since the international tax regime, as it applies today, fails to be in line with economic reality, the credit method may be deployed as an anti-tax abuse tool to counteract any sheltering of volatile production factors such as liquid assets and intangibles in low tax jurisdictions by taxpayers who employ the flawed international tax regime for their individual benefit.[217] Only in such a case, a 'topping-up' tax imposed by State R (or the home state in European Union law terms) may be justified.

Presented like this, the credit method may function as an anti-tax abuse measure in the fight against what is commonly considered by tax lawyers as 'harmful' tax competition. Illustrative for this is the approach adopted by several states, which states seek to promote import neutrality as a default tax policy approach for double tax relief purposes. For instance, the Netherlands, applies 'switch-over-to-credit-mechanisms' for the purpose of countering any sheltering of portfolio investment income in low-tax jurisdictions on the basis of a blend of both export neutrality and anti-tax avoidance considerations.[218]

All import neutrality promoting territorial systems distort outbound investment

The concept of import neutrality also has certain shortcomings attached to it. Countries that adhere to the notion of import neutrality treat economic operators who perform their economic activities both within the source state as well as abroad differently – i.e., unequal and therefore non-tax neutral – vis-à-vis economic operators who perform their economic activities solely within the source state.

If the source state subjects both to the same domestic tax burden, the source state imposes an obstacle on the economic operator investing abroad. Income that is not attributable to the source state, foreign income, is ignored upon the calculation of the tax burden in the source state. This is in accordance with the benefits principle, but not with the ability to pay principle. In determining the domestic tax burden, the source state ignores the ability of the economic operator that invests abroad to pay tax; perhaps it produces a loss abroad affecting its ability to pay in the source state. Conversely, this is not the case with economic operators that solely invest in the source state. Generally, their ability to pay is taken into consideration as domestic source profits and domestic source losses may be offset against each other.

This leads to inequality caused by the source state. Tax systems promoting import neutrality subject outbound capital movements to taxation. Outbound investment is distorted unilaterally

[216] Vann forwards the analytically identical question in Richard J. Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World', 2 *World Tax Journal* 291 (2010), at 309.
[217] See for a comparison the remarks by the Dutch Ministry of Finance in 1998 on the Dutch international tax policy, the 'Notities inzake het Nederlands fiscaal verdragsbeleid', Vakstudie-Nieuws 1998 No. 22, at section 1.3.2 and 4.3.1.3, referring to the adopting of the concept export neutrality on the basis of anti-tax abuse considerations.
[218] See for some details, Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international* (2011) 447-470, at section 3.

by the taxing source state. Import neutrality promoting tax systems, hence, produce obstacles. Tax systems promoting import neutrality create inequitable and inefficient tax treatment of production factor exports.[219]

In the international tax literature, the obstacles imposed under import neutrality promoting tax systems are sometimes referred to or labeled as 'disparities' 'dislocations' or 'tax base fragmentations'.[220] Confronted with their distortive effects these subsequently are generally considered as an inherent – and therefore apparently justified – consequence of the adoption of a territorial tax system. I find it somewhat difficult to appreciate dislocations in the international tax systems of states, merely by reason of their presence in these systems. The term 'dislocations', in my view, is just another label for unequal treatment in equal circumstances. From that perspective the term is just another label for inequity.

An example: 'Quincy's Records Company'

Please let me illustrate the obstacles imposed in a territorial system by way of the following numerical example.[221] Let us suppose a base case (scenario 1) in which corporate taxpayer Quincy's Records Company derives income from sources (e.g. branches) a) and b) situated in an imaginary State called X(ypho). Xypho has a territorial tax system. The operations carried on through branch A yield a positive return (profit) of 100. The operations carried on through branch B yield a negative return (loss) of 40. Xypho takes taxpayer Quincy's Records Company's ability to pay into account and permits horizontal loss compensation, i.e., the offset of losses realized within the tax year, and taxes Quincy's Records Company on the balance of its business income of 60.

Now let us suppose the alternative to the base case – i.e., scenario 2 – in which the same taxpayer Quincy realizes the loss of 40 from the operations in branch B, which have now been carried out in an imaginary State called Y(phlo). In situation 2, Xypho does not take taxpayer Quincy's Records Company's ability to pay into consideration, nor does it permit horizontal cross-border loss compensation under its territorial tax system. It taxes Quincy's Records Company for the income of 100. Xypho solely takes into account the profit realized on the operations in branch A situated within its territories and disregards the loss Quincy's Records Company has suffered through branch b situated in Yphlo. By assessing the taxable income of taxpayer Quincy's Records Company in situation 2 at 100 instead of 60, Xypho does not take Quincy's Records Company ability to pay into consideration, whereas it does so in the comparable situation 1. In the event Xypho applies a proportional tax rate, Quincy's Records Company's tax burden in Xypho increases by a factor of 1.667. Depending on the size of the foreign source loss Quincy's Records Company could even end up paying more tax than it earns.[222]

Only because taxpayer Quincy's Records Company crossed Xypho's tax border by relocating branch B to Yphlo, Xypho unilaterally imposes an obstacle. Even in the event that Yphlo acknowledges the loss of 40, allows vertical loss compensation – i.e., compensation of losses realized in another tax year – by carrying the loss forward to the next tax year, the obstacle imposed by Xypho is still there. Because even under the presupposition that taxpayer Quincy's Records Company will be able to realize a profit from the operations in branch B situated in Yphlo in the next year, taxpayer Quincy's Records Company still suffers a liquidity

[219] 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. See also Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55.
[220] See B.J.M Terra et al, *European Tax Law* (2012), at 65-66. See also Dennis M. Weber, 'Vpb 2007. Een stelsel gebaseerd op het territorialiteitsbeginsel: EG aspecten en contouren', 133 *Weekblad Fiscaal Recht* 1297 (2004), at section 3.2.2.
[221] See for a comparison, Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55, where analytically equivalent reasoning is made use of to criticize the replacing in the Dutch corporation tax system per 1 January 2012, of the Dutch style 'tax exemption with regression method' for something that is referred to as a 'base exemption for foreign business income'. The 'base exemption for foreign income' renders outward bound investment comparatively less attractive in a similar manner as a territorial system. That is, save for some exceptions which are elaborated upon in that publication.
[222] See for a comparison Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 840.

disadvantage in situation 2 vis-à-vis situation 1 due to the unfavorable tax treatment of taxpayer Quincy's Records Company in Xypho. After all, taxpayer Quincy is deprived of the tax paid on the difference between 100 and 60 for a period of one year, producing what may be referred to as a 'temporization difference'.[223]

All import neutrality-based territorial tax systems, as well as worldwide tax systems that provide base exemptions for foreign income currently present in the international tax regime fail to properly take the economic operator's ability to pay into account. By accordingly creating a bias towards domestic investment all these systems consequently impose an obstacle on outward bound investment.[224] The Netherlands for example allows resident taxpayer individuals with foreign loss-rendering income to offset their cross-border losses against their domestic income while depriving it as a rule for non-resident taxpayers with losses from foreign sources. The Netherlands accordingly subjects its non-resident taxpayers to such an obstacle. One only has to read 'the Netherlands' in 'Xypho' and 'non-resident taxpayer' in 'taxpayer Quincy's Records Company' to reach this conclusion. And it was exactly this disadvantage that led the Court of Justice in the *Renneberg* case to observe the difference in tax treatment between non-resident taxpayers in comparison with resident taxpayers in the Dutch international income tax system to be discriminatory.[225]

Dislocations can lead to both comparatively competitive advantages and comparatively competitive disadvantages for both for economic operators going abroad and those staying at home.

An example of a distortive advantage that a cross-border economic operator may enjoy vis-à-vis its domestic peer is that territorial tax systems promote so-called income splits; typically in the area of income taxation where the tax rate structures often progressively slope upwards. The availability of income splits produced under territorial tax systems allow the internationally active economic operator to escape from any progressiveness of rate structures in the relevant tax system. As the taxpayer involved derives its income from sources dispersed across more than a single tax jurisdiction, these are all taxed locally at moderate progressiveness in the countries of source. A comparative reduction in the overall progressiveness is the outcome, i.e., relative to the domestic equivalent.

A typical example of a distortive tax-disadvantage that a cross-border economic operator is confronted with whereas its domestic peer is not, is the fact that no losses may be imported under territorial tax systems whereas domestic losses and profits may typically be offset against one another.[226] Furthermore, territorial tax systems typically subject outward bound modes of transfers of capital assets to 'exit taxes' that become immediately due upon their tax border crossings. Moreover, territorial systems exempt currency exchange results on foreign source proceeds from the tax base making outward bound investments less attractive than domestic investments. In the aforementioned numerical example of our taxpayer Quincy's Records Company that invested abroad, the dislocation at hand – keeping foreign source income outside of the domestic tax base – ends unfavorably. These features, as said, cause territorial systems to create a bias towards investment in the country in which the taxpayer is already economically active.

European Union law does not provide an answer either

[223] Cf. Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55, referring to this effect as a 'temporization difference'.
[224] See for a comparison. 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.
[225] Cf. Court of Justice, case C-527/06 (*Renneberg*). But see Dennis M. Weber, 'Vpb 2007. Een stelsel gebaseerd op het territorialiteitsbeginsel: EG aspecten en contouren', 133 *Weekblad Fiscaal Recht* 1297 (2004), at section 3.2.2.
[226] See e.g., 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 October 2001, COM(2001) 582 final., at 10-13; at 12: *"The problem of cross-border loss offset is at the same time one of the most important issues for industry and yet the most difficult to address through specific measures."* See also 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.

Within the context of the European Union, unfortunately European Union law, as it currently stands, does not provide a consistent tax neutrality concept either. Both primary European Union law and secondary European Union law do not give preference to either import neutrality or export neutrality or the corresponding double tax relief methods that seek to promote these policy objectives (i.e., respectively exemption and credit).[227]

As far as the application of primary European Union law, more in particular the interpretation of the fundamental freedoms, is concerned the Court of Justice's case law reveals that the court considers the pursue of both import neutrality and export neutrality by European Union Member States to be both compatible and incompatible with the fundamental freedoms.

The Court of Justice's ambiguous approach towards the distortive effects of import neutrality promoting tax systems

With respect to the Court's approach towards the distortive effects of an import neutrality approach based tax system, the following may be mentioned (see also section 6 of this chapter).[228]

In *Futura* the Court of Justice considered it a disparity that under Luxembourg corporate tax law a non-resident taxpayer's foreign loss cannot be offset against Luxembourg source profits – i.e., the distortive effect under an import neutrality based taxation system as referred to in the above paragraphs.[229] In *Daily Mail* the Court of Justice considered the UK law clearance requirement allowing corporate emigration only upon the settlement of the corporate tax position – i.e., the levy of an exit tax which is a distortive effect under an import neutrality based tax system – to be a disparity as well.[230]

On the contrary, in the *Lasteyrie* and *N.* cases the same Court of Justice considered the Dutch and French exit taxes levied upon the emigration of substantial shareholders-individuals to a foreign country – i.e., conceptually the same distortive effect of a territorial system as in Daily Mail but in the area of individual taxation – to constitute an unjustified restriction if the tax liability becomes immediately due.[231] In *National Grid Indus*, the Court however observed something else.[232] Similar to its observations in *N.* and *Lasteyrie* it observed the levy of an exit tax in corporate taxation that becomes immediately due in the event of an outward bound movement of the taxpayer or its operations an unjustified restriction. However, contrary to its rulings in *N.* and *Lasteyrie*, the court observed in *National Grid Indus* that this only holds true when the taxpayer is ineligible for an interest bearing deferral of the tax collection. Accordingly, in *National Grid Indus* the Court of Justice effectively allows for an immediately payable exit tax upon outbound movements – i.e., as an interest bearing deferral of the tax collection economically equates an immediate tax collection. Oddly enough, in *Gielen* the Court of Justice observed that the possibility in the Dutch tax regime for non-resident taxpayers to opt for non-discriminatory tax treatment was insufficient to resolve the non-discriminatory tax treatment of the non-resident taxpayer in the case at hand – see further section 5.5.2 of this chapter.[233]

The Court of Justice steers another course yet again in *Renneberg*, already mentioned above.[234] *Renneberg* dealt with the impossibility under Dutch tax law for non-resident taxpayers to offset a foreign source loss against a Dutch source profit. The issue is conceptually akin to that dealt with in *Futura,* save for the fact that *Renneberg* was about a non-resident taxpayer/individual who suffered a foreign source loss whereas the taxpayer in

[227] See Klaus Vogel, 'Which Method Should the European Community Adopt for the Avoidance of Double Taxation?', 56 *Bulletin for International Taxation* 4 (2002), at section 3 and Eric C.C.M. Kemmeren, 'Source of income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach', 60 *Bulletin for International Taxation* 430 (2006), at section 4.
[228] For an in-depth analysis of this case law, see Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010).
[229] See Court of Justice, case C-250/95 (*Futura*).
[230] See Court of Justice, case 81/87 (*Daily Mail*).
[231] See Court of Justice, cases C-9/02 (*De Lasteyrie du Saillant*) and C-470/04 (*N.*).
[232] See Court of Justice, case C-371/10 (*National Grid Indus*).
[233] See Court of Justice, case C-440/08 (*Gielen*).
[234] See Court of Justice, case C-527/06 (*Renneberg*).

Futura is a non-resident corporate taxpayer who suffered a foreign source business loss. However, contrary to its observation in *Futura* that the issue constituted a disparity, the Court however observed in *Renneberg* that the differential in tax treatment of the non-resident taxpayer vis-à-vis the resident taxpayer constituted an unjustified discrimination.

The Court of Justice conceptually went even a step further in *Bosal*.[235] Bosal dealt with the non-deductibility of foreign source expenses – expenses incurred for the financing of a substantial equity investment in a foreign company – under the Dutch base exemption for gross proceeds from substantial equity investments; the Dutch participation exemption regime. The non-deductibility of the foreign source expenses is a distortive property of an import neutrality based international tax system, as it hinders outbound investment. The Court of Justice found the deduction limitation a restriction that could not be justified, even though the expenses were effectively incurred abroad.

An approach similar to that in *Bosal* may be identified in *Argenta*.[236] *Argenta* dealt with the notional deduction for the opportunity costs of equity capital in the Belgian corporation tax – the allowance for corporate equity concept underlying such a deduction is addressed in Chapter 5, section 6. The deduction was however effectively limited to equity capital relating to Belgian source profits. In effect Belgium effectively exported the deduction by exempting the deduction from the tax base in a manner that corresponded to the exclusion of foreign source profits from the Belgian taxable base. This property of the Belgian system is effectively a distortive element of an import neutrality based international tax system, as it renders outbound investment comparatively less attractive. Similar to its observations in *Bosal*, the Court of Justice found this to be an unjustifiable restriction, even though the deduction limitation effectively related to the corporate taxpayers' foreign source income.

The same holds true for the Court of Justice's approach in *Rewe Zentralfinanz*.[237] *Rewe* dealt with a cash flow disadvantage imposed by Germany with respect to the corporate taxation of proceeds from cross-border indirect investments vis-à-vis the taxation of proceeds from domestic indirect investments. The timing of the write-off differed depending on the tax residence of the respective legal entity in which the German corporate body held its equity investment. To the extent an equity investment in a company having its tax place of residence in Germany was concerned, the German corporate tax legislation allowed for an immediate write-off for corporate tax 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 Member State, the German corporate tax legislation merely allowed for a write-off for tax base calculation purposes to the extent the equity investment produced positive earnings. As costs typically precede profits, equity investments in German companies are treated favorably for tax purposes – *tax write-off today* – vis-à-vis equity investment in non-German European Union companies – *tax write-off perhaps tomorrow*. The Court of Justice ruled that the different tax treatment was incompatible with the freedom of establishment. It substantiated its observation by referring to the imposed cash flow disadvantages hindering outward bound investment.[238]

This said, in *Marks & Spencer II* the court yet again took a different course.[239] This time the observations of the Court of Justice were analytically opposite from its observations in *Bosal* and *Renneberg*. In *Marks & Spencer II*, the court reviewed the impossibility to pool domestic source intra-firm inter-entity profits and foreign source intra-firm inter-entity losses under the United Kingdom group relief regime. That is, an import neutrality promoting taxation system

[235] See Court of Justice, case C-168/01 (*Bosal*).
[236] See Court of Justice, case C-350/11 (*Argenta Spaarbank*). For some analysis of the *Argenta* case, see Luc De Broe, 'The ECJ's Judgment in Argenta: Narrow Interpretation of 'The Preservation of the Balanced Allocation of Taxing Rights between Member States'. A Headache for Designers of Tax Incentives in the Union', 22 *EC Tax Review* 210 (2013), at 210-212.
[237] See Court of Justice, case C-347/04 (*Rewe Zentralfinanz*).
[238] See for a comparison also Court of Justice, case C-35/08 (*Busley*). In Busley the court considered the German individual income tax legislation incompatible with the fundamental freedoms to the extent that it did not allow taxpayers to take into account for tax calculation purposes a deduction for losses suffered from the commercialization of foreign source real estate.
[239] See Court of Justice, case C-446/03 (*Marks & Spencer II*).

relating to non-repatriated foreign source corporate profits. The court ruled that the inability to pool foreign source losses and domestic source profits was a restriction that could be justified as long as the vertical loss set-off possibilities in the foreign source taxing jurisdiction had not been exhausted – i.e., the so-called 'M&S-exception'. The court accordingly considered the resulting unilaterally imposed timing disadvantage not to constitute an infringement of the fundamental freedoms in that instance. A conditional loss set-off entitlement for a foreign source business loss suffered today apparently suffices.[240] Notably, the Court of Justice resorted to this approach again in its ruling in A Oy.[241]

Yet, in *Lidl* the court conceptually moved away from earlier case law yet again.[242] That is, not only from the approaches taken in *Marks & Spencer II*, but also from that in *Bosal* and *Renneberg*. In *Lidl*, the court shows evidence of reverting back towards its original approach in *Futura*. In *Lidl* the Court of Justice dealt with the impossibility for German resident taxpayers to offset foreign source losses against domestic source profits under the German import neutrality promoting juridical double tax relief measure, a base exemption for foreign source income. The obstacle imposed by Germany is conceptually similar to that in *Renneberg* and *Futura*, with the exception that the taxpayer in *Lidl* is a resident taxpayer who suffered a foreign source loss. The court ruled that the German tax treatment constituted a justified restriction. It did not refer to the aforementioned M&S-exception.

In *X Holding* the Court of Justice upheld its approach taken in *Lidl*.[243] *X Holding* dealt with the impossibility to consolidate foreign group companies under the Dutch corporate tax legislation for tax purposes– thereby in effect exempting foreign source intra-firm inter-entity profits from the Dutch tax base, i.e., a distortive implication under the import neutrality based Dutch business income tax system. The court rules that this was a justified restriction. Also in *X Holding*, the Court of Justice did not refer to the M&S-exception. As a result some have argued that the court had disposed of it.[244] However, in its later *A Oy* ruling, the court went back to the M&S-exception once again.

The final noticeable ruling in the list is *K*. dealing with the unavailability under the Finnish individual income tax regime for resident taxpayers to offset a foreign source loss resulting from the disposal of foreign real estate against domestic source income.[245] The court ruled that the Finnish tax treatment constituted a justified restriction. The taxpayer in this case however was effectively deprived from its loss-offset possibilities, as the country in which the real estate was situated, France, also did not allow for a vertical compensation of the real estate loss – at least that seemed to be the case as inferred from the Court's understanding on the facts as submitted to it. The court upheld the Finnish tax treatment paying lip service to the M&S-exception. It seems odd that the possibility to invoke the M&S-exception and import a foreign source loss into the home state offset against a local profit seems to depend on the

[240] It should be said, though, that there is some legal uncertainty at this point. In the joined cases C-397/98 and C-410/98 (*Metallgesellschaft / Hoechst*) the Court of Justice arrived at an opposite conclusion as regards the European Union 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. See for some extensive analyses, Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55.
[241] See Court of Justice, case C-123/11 (*A Oy*).
[242] See Court of Justice, case C-414/06 (*Lidl*).
[243] See Court of Justice, case C-337/08 (*X Holding*).
[244] See e.g., the Opinions of Advocate General Kokott in Court of Justice cases C-123/11 (*A Oy*) and C‑18/11 (*Philips Electronics*). The Court of Justice did not refer to its 'M&S exception' in its rulings in cases C-337/08 (*X Holding*) and C-414/06 (*Lidl*). This has lead Advocate General Kokott to observe in her opinions in *Philips Electronics* and particularly *A Oy* that little room, if any, remains for the M&S exception to be acknowledged under current primary European Union law. Kokott 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 the Member States of the European Union to adopt full-fledged territorial taxing systems. It is noted that such tax systems, indeed, promote production factor import neutrality. However, simultaneously they hamper outbound investment. It is difficult to appreciate why the internal market should necessarily favor import neutrality over export neutrality. In the internal market, intra-European Union investment is directed both inward bound and outward bound. Why should the Member States be permitted under primary European Union law to disregard jurisdiction neutrality when taxing the returns from the latter? Cf. Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55.
[245] See Court of Justice, case C-322/11 (*K.*).

question of whether an *a priori* available loss offset possibility in the host state has been exhausted ex post – in which case the M&S-exception can be invoked– or whether such a source state loss offset possibility is *a priori* unavailable – in which case the M&S-exception cannot be invoked. Accordingly, the Court of Justice has created a difference in treatment under European Union law dependent on whether the case concerns an *a priori* or an *ex post* exhausted loss compensation possibility. I find it hard to get my mind around this analytically.

The Court of Justice's ambiguous approach towards the distortive effects of export neutrality promoting tax systems

With respect to the Court's reaction on the distortive effects of adopting an export neutrality promoting international tax system, things are not looking up either. In *Columbus Container* the Court of Justice ruled that the 'top-up' effect under the application of the German ordinary tax credit mechanism – i.e., a double tax relief mechanism promoting a distortive export neutrality approach – with respect to foreign source income constituted a disparity.[246] The Court argued that comparable German tax residents with German source income would effectively be liable to pay the same amount of tax as the taxpayer in the case at hand.

The Court however did something else in *Cadbury Schweppes*.[247] This case involved the United Kingdom's controlled foreign company legislation seeking to tax the low-taxed passive income items of a controlled foreign subsidiary in the hands of the resident taxpayer parent company while providing a credit for underlying foreign double tax relief purposes. That is, an approach promoting export neutrality with respect to non-repatriated foreign source profits, 'topping-up' the tax burden to United Kingdom levels. In contrast to its ruling in *Columbus Container*, the Court of Justice found that a restriction may only be justified under anti-abuse considerations. It rejected the argument that comparable domestic firms with domestic source income would effectively be liable to pay the same amount of corporation tax as the taxpayer in the case at hand.

In stark contrast to its approach in *Cadbury Schweppes*, the Court of Justice oddly enough considered the United Kingdom's credit for underlying foreign tax with respect to repatriated foreign source profits compatible with the fundamental freedoms in *FII*.[248] In *FII* the court ruled that the internal market distortions that result from the application of an indirect credit method – i.e., an economic double tax relief mechanism promoting export neutrality – a disparity. The court considered the top-up effect not problematic under the free movement rights. It repeated its observation on the compatibility of export neutrality promoting indirect credit systems upon the repatriation of after tax profits at this point in the *Haribo* and *Salinen* cases. [249]

To be honest, this mind-blowing 'roller-coaster-approach' of the Court of Justice towards the concepts of import neutrality and export neutrality leaves me quite puzzled.

The ambiguous approach in secondary European Union law towards the distortive effects of import neutrality and export neutrality promoting tax systems

Things unfortunately are not much better when it concerns the application of secondary European Union law, for instance the Parent-Subsidiary Directive and the Interest & Royalty Directive.[250] These instruments seek to ensure single taxation of respectively income from inter-company equity financing arrangements, debt financing arrangements and licensing arrangements. An analysis of these instruments reveals that a decision on a favored neutrality concept has not been made in these areas either. It seems that the Parent-Subsidiary

[246] See Court of Justice, case C-298/05 (*Columbus*).
[247] See Court of Justice, case C-196/04 (*Cadbury Schweppes*).
[248] See Court of Justice, case C-446/04 (*FII 1*).
[249] See Court of Justice, joined cases C-437/08 C-436/08 (*Haribo & Salinen*) and the Opinion of Advocate General Kokott in these cases that she delivered on 11 November 2010.
[250] See respectively the Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States and the Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

Directive does not decide between import neutrality and export neutrality, while the Interest & Royalty Directive effectively favors the promotion of export neutrality.

The Parent-Subsidiary Directive seeks to secure the single taxation of corporate profits at source. Under its application, eligible inter-corporate cross-border dividend payments may not trigger economic double taxation. That is achieved by prohibiting the countries to which the directive applies from levying source taxes on eligible inter-company outbound dividend payments. Furthermore, the directive requires that the countries involved grant relief for economic double taxation with respect to eligible inter-company inbound – taxable – dividend receipts. That is, either under the base exemption method, i.e., an import neutrality promoting double tax relief mechanism. Or under an indirect credit method, i.e., an export neutrality promoting double tax relief mechanism. Accordingly, as the Parent-Subsidiary Directive allows the European countries involved to decide between these alternative economic double tax relief mechanisms, it does not decide on the policy to be followed within the internal market, the envisaged area without internal frontiers. Both import neutrality and export neutrality are approved.

The Interest & Royalty Directive seeks to secure the single taxation of corporate profits as well. Under its application the countries to which the directive applies are prohibited from levying source taxes regarding eligible inter-corporate outward bound interest payments and royalty payments. Accordingly the choice has been made that the taxation of inter-corporate proceeds from debt capital financing and intellectual property licensing arrangements in the recipient company's country of tax residence is allowed. The directive thereby adopts an export neutrality favoring policy, at least implicitly. The effective taxation in the recipient's home state has the effect that the creditors and licensees involved are taxed at home state levels, irrespective of the geographical location of their debt and intellectual property investments. Hence, an approach promoting export neutrality may be understood accordingly.

Murky approach towards tax neutrality in European Union law does not enhance the operation of the internal market

I doubt whether such a murky approach towards tax neutrality as taken within the European Union enhances the intended objective of equity and neutrality within the internal market without internal frontiers. Furthermore, the absence of a European Union tax neutrality concept leads to some conceptual complications. For example, where the European Union Member States – such as the Netherlands[251] and Germany[252] – apply anti-tax abuse provisions switching over from exemption (import neutrality) to indirect or direct credit (export neutrality) in cases where corporate taxpayers shelter mobile assets in low tax jurisdictions.

Primary European Union law, as it currently stands, does not provide an answer to the question whether one is dealing with an acceptable double tax relief method,[253] or an anti-tax abuse measure to be justified by overriding reasons in the general interest[254].[255] Secondary, European Union law does not make a decision either. Taking the aforementioned shortcomings with the import neutrality concept in conjunction with the inadequate international tax regime's building blocks into account, the answer to that question should perhaps be the latter: anti-tax abuse considerations.[256]

[251] The Dutch international tax system contains a fixed indirect credit mechanism for passively held substantial equity investments in companies that are subject to a low level of taxation on income derived. In such an event, the Dutch Corporate Income Tax Act (CITA) switches over from the application of the participation exemption to the indirect credit mechanism. The regime is currently laid down in Article 13 and Article 13aa in conjunction with Article 23c of the Dutch CITA.
[252] I.e., the 'switch-over' that was at stake in Court of Justice, case C-298/05 (*Columbus*).
[253] See Court of Justice, case C-298/05 (*Columbus*).
[254] Cf. Court of Justice, case C-196/04 (*Cadbury Schweppes*) and Opinion Advocate-General Mengozzi in Court of Justice, case C-298/05 (*Columbus*).
[255] The decision of the Court of Justice in case C-298/05 (*Columbus*), for an 'export neutrality entails a disparity'-approach instead of an 'export neutrality entails an anti-tax abuse'-approach as it did in Court of Justice, cases C-196/04 (*Cadbury Schweppes*) and C-425/06 (*Part Service*) consequently seems based on analytically arbitrary grounds.
[256] See for a comparison Klaus Vogel, 'Which Method Should the European Community Adopt for the Avoidance of Double Taxation?', 56 *Bulletin for International Taxation* 4 (2002), at section 3.

The concept of 'inter-nations neutrality' does not either

As an alternative to the concepts of import neutrality and export neutrality, Vogel introduces the notion of 'inter-nations neutrality'.[257] Vogel argues that worldwide economic efficiency is best promoted when states do not employ their sovereign taxing powers to influence the relative prices in other states.

Pointing at the benefits principle, Vogel concludes, if I am not mistaken, that worldwide economic efficiency requires that an economic operator that performs economic activities within a state or a domestic market and consequently utilizes the public goods provided by that state must be subject to the same local tax burden as any other person whose circumstances are similar and who utilizes the public goods provided by that state to the same extent. Vogel refers to this as inter-nations neutrality.[258] He argues that inter-nations neutrality can only be achieved by allocating the profits from cross-border business activities to the geographic location where the economic activities actually take place and where the business income is produced – economic presence; nexus.[259] My impression is that Vogel's neutrality concept basically functions in a manner similar to import neutrality. By only taking the benefits principle into account, hence without fully considering the implications of the ability to pay principle, the application of the inter-nations neutrality concept produces the dislocations considered inequitable in the above.

In sum, both export neutrality and import neutrality – or inter-nations neutrality – result in unequal tax treatment in equal circumstances. Hence, the adoption of one of these neutrality concepts in an international tax system inevitably leads to unilaterally imposed obstacles. It follows from the above that these concepts seem insufficient to satisfactorily provide for an overall tax neutrality concept.

3.3 Fairness within an international tax system; internal equity and production factor neutrality

3.3.1 Tax burden should not affect residence location and investment location

Both the concepts of export neutrality and import neutrality produce inequities in the international tax systems of states and with that the imposing of distortive obstacles to the functioning of the global market. It accordingly seems necessary to develop an alternative.[260]

An alternative neutrality concept has to meet the following preconditions. The fiscal sovereignty of states needs to be respected as a given. That is as in this part of the study the object of the assessment is the search for a solution to unilaterally imposed obstacles, rather than a solution to disparities and inadequacies. As said, these disparities and inadequacies mentioned in Chapter 1 are substantively addressed in Chapters 4 through 6.

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[257] See Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part II)', 10 *Intertax* 310 (1988), at 313-315 and Klaus Vogel, 'Which Method Should the European Community Adopt for the Avoidance of Double Taxation?', 56 *Bulletin for International Taxation* 4 (2002), at 4-8. See also Eric C.C.M. Kemmeren, 'Source of income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach', 60 *Bulletin for International Taxation* 430 (2006), at 438-441 and Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006), at 266-269.

[258] See Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part II)', 10 *Intertax* 310 (1988), at 314. Vogel refers to the connection between the benefits principle and the efficiency of the administrative machinery of government ('administrative net output').

[259] See Klaus Vogel, '"State of Residence" may as well be "State of Source" – There is No Contradiction', 59 *Bulletin for International Taxation* 420 (2005), at 420-422.

[260] Absent a complete harmonization of direct tax systems, an economic policy of a nation state simultaneously promoting both the import and export of the production factors capital and labor is commonly understood as being impossible to achieve. See Hugh J. Ault et al, 'Taxation and Non-discrimination: A Reconsideration', *2 World Tax Journal* 101 (2010), at section 1 and also Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 171-172. See also Ruth Mason, 'Tax Discrimination and Capital Neutrality', *2 World Tax Journal* 126 (2010), at section 3. I respectfully disagree; see further hereunder.

The required fairness concept should promote equality and neutrality with regards to both cross-border and domestic business activities, irrespective of the direction of the capital movement. It should accordingly promote equity and neutrality regarding both inbound movements and outbound movements of economic operators and their operations. Both the benefits principle and the ability to pay principle need to be acknowledged as well.

This means that whenever a state exercises its sovereign taxing powers and subjects an economic operator (taxpayer) to tax for having a nexus in that state, the tax burden imposed by that state should be equal. The tax burden should be the same regardless of the taxpayer's place of tax residence, i.e., to appreciate the benefits principle. Moreover, the burden of tax should be equal irrespective of whether this taxpayer derives its business income solely in that state or in various states – i.e., to appreciate the ability to pay principle.

These presuppositions boil down to the following norm:

> *"the domestic tax burden on the proceeds derived from the cross-border business activities of firms should equal the domestic tax burden on the proceeds derived from the non-cross-border (i.e., purely domestic) business activities of firms."*

In the event that the tax burden differs because of the taxpayer's tax place of residence or the geographic locations of its investments, an obstacle has been imposed by that taxing state. Namely, in such a case the difference in tax burden can necessarily only be caused by the taxpayer's place of residence or the fact that it operates its business activities in various states rather than within a single taxing jurisdiction.

This objective can be achieved by combining the – what I consider – best elements in existing theories, concepts and practices. The concepts of import neutrality and export neutrality are conceptually integrated into one another. From the export neutrality concept, I extract the element 'worldwide taxation'. By doing so, the ability to pay principle is acknowledged. From the import neutrality concept, I extract the element 'economic presence', or 'nexus'. Through this, the benefits principle is acknowledged.

The fiscal sovereignty of states needs to be respected as a given. Foreign entitlements to subject business income to tax should be respected. Single taxation of the taxpayer's business income derived should be ensured as well. That would secure effective taxation as close to its geographic source as possible.

To respect the fiscal sovereignty of states and to achieve single taxation of the taxpayer's business income, the adoption of an internally equitable and production factor neutral double tax relief mechanism is required to eliminate juridical double taxation. As the commonly applied ordinary credit for foreign tax (export neutrality) and the base exemption for foreign income (import neutrality) mechanisms prove to distort inbound and outbound investment respectively, an alternative is necessary. The required double tax relief method may be achieved by the integration of the credit method (export neutrality) and the exemption method (import neutrality) into one combined method.

In this way, a concept has been modeled that results into equality – equity and neutrality – within an international tax system for taxpayers who operate in various tax jurisdictions. I plainly refer to it as 'internal equity' and 'production factor neutrality'.

3.3.2 Worldwide taxation in the event of a domestic nexus; double tax relief in the form of a credit for domestic tax attributable to foreign income regarding a foreign nexus

3.3.2.1 Worldwide taxation if domestic nexus, irrespective of tax place of residence

The exercise results into the unlimited tax liability for the worldwide business income of the relevant economic operator having nexus within the taxing state – worldwide taxation upon

domestic nexus irrespective of the place of residence. The approach advocated leads to worldwide taxation of all economic operators who derive income from domestic sources in each state in which that economic operator conducts economic activities. That is, irrespective of whether these taxpayers reside outside or within the territories of the respective taxing state.

A taxpayer would be subject to unlimited tax liability within a tax jurisdiction when that taxpayer has an economic presence within that jurisdiction. For instance by conducting a business activity within its territories. The threshold of a minimum economic presence has then been met. The approach advocated would accordingly link to the source concepts utilized in current international taxation such as the concept of permanent establishment and the place of effective management.[261] At least for now, at this step in the analysis undertaken in this study. The worldwide taxation as advocated in this study is not inextricably linked to the permanent establishment and place of effective management thresholds to establish nexus, though. Nexus expressions in the international tax regime are discussed as a separate matter in Chapter 6.

3.3.2.2 Double tax relief regarding foreign nexus: credit for domestic tax attributable to foreign income to render investment location indifferent regarding tax burden imposed

The exercise further results into the 'credit for the domestic tax that is attributable to the foreign income items'. This double tax relief methodology has been extracted from current Dutch tax law by analogy, as it currently applies to resident individual taxpayers deriving active income from foreign sources.[262] This double tax relief mechanism applied in the Dutch corporate tax system as well, i.e., with respect to the foreign source active income items of Dutch resident corporate taxpayers. However, regrettably the Dutch tax legislator abolished this double tax relief mechanism from the Dutch international corporation tax system for budgetary reasons with effect from 1 January 2012. In corporate taxation, the double tax relief mechanism was replaced by something that is referred to in Dutch tax practice as the 'base exemption for foreign business income'.[263]

The advocated Dutch-style double tax relief provided in respect of foreign business proceeds is determined by reference to the geographic profit division methodologies as currently in place in the international tax regime – i.e., separate accounting and the arm's length standard, SA/ALS. At least for now, at this step in the analysis undertaken in this study. The double tax relief mechanism advocated here is not inextricably linked conceptually to profit division methods referring to SA/ALS. The same holds regarding the question as to how to define the corporate tax base. Notably, taxable profit determination and taxable profit allocation are discussed as analytically separate matters in Chapters 5 and 6.

[261] One may also consider in this respect the alternative expressions of the source concepts currently in place in the international tax regime, such as the place where the immovable property is situated, the place where the company paying the dividends has its effective place of management, or the place where the interest and royalties arise. With respect to source taxes levied on portfolio dividend, interest and royalty payments one may think of crediting them against corporate tax levied. With respect to transactions within a group of affiliated companies (intra-group dividends and intra-group transactions), one may think of adopting mandatory cross-border tax consolidation arrangements or arrangements dealing with the (mandatory) transparency for corporate tax purposes of group companies. These issues however exceed the scope of this chapter and will therefore not be further discussed in detail. Notably, the subject of tax grouping is dealt with extensively in Chapter 4. The subject of attributing tax base to taxing jurisdictions (nexus and allocation) is extensively dealt with in Chapter 6.

[262] This double tax relief methodology is laid down in the Dutch Unilateral Double Tax Relief Decree of 2001. See for some details on the mechanism, Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international (*2011), at sections 1 and 2. Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010), at section 3.

[263] See for an in-depth assessment of the current double tax relief mechanism Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55.

3.3.2.3 *Identical tax systems hypothesized at both sides of the tax border to exclude disparities from the analysis; 'internal consistency'*

Before leaping to an exploration of the meaning, implications, effects, and consequences of this approach in sections 4 and 5 of this chapter, the following remarks should be made as to the mode of the analysis undertaken. The purpose of this is the following.

This study seeks to provide a sound assessment of the effects of the advocated approach of subjecting taxpayers with domestic nexus to worldwide tax liability, while at the same time providing for double tax relief in respect of foreign income in accordance with the Dutch-style tax exemption method. For that purpose, the assumption is made that both nation states involved in a cross-border economic environment adopt the exact same methodology at both sides of the tax border. Only when there are no mutual divergences between the respective states international tax systems – i.e., disparities and mismatches in the international tax regime[264] – it is feasible to analytically isolate unilaterally imposed obstacles by the international tax systems of the states under review.

Such a 'thought experiment' demonstrates that the approach as advocated in this step entails an imposition of equal tax burdens in both domestic and cross-border scenarios. The approach illustrates that the crossing of a tax border in that event would not affect the tax burden whatsoever. The purpose of the exercise therefore is to illustrate that the transfers of tax residence or the movements of production factors across tax borders would not result in unilaterally imposed obstacles that distort the neutral and equitable operation of the increasingly borderless global market envisaged.

Were the tax burden to alter upon such a transfer of the place of tax residence or the business operations under the thought experiment, the distortive effects of the tested system would be proved. That would accordingly enable the illustration of the existence of an obstacle in system. Hence, the thought experiment may also be worth exercising for the purpose of illustrating the absence of a distortive feature. As will be shown, the advocated system operates in an obstacle-free manner; the tax burden imposed by the taxing state would be identical in both domestic and cross-border environments. Under its application all countries involved would tax the fraction of the worldwide income to which they are entitled.

The mode of the assessment equals that under the so-called 'internal consistency test' as it applies under US Constitutional law to assess whether the US state income tax systems infringe upon the constitutional rule not to distort interstate commerce relative to intra-state commerce. US constitutional law requires the states to adopt a tax system that operates *"such that, if applied by every jurisdiction, it would result in no more than all of the unitary business' income's being taxed"*, i.e., the 'internal consistency test'.[265] A challenged tax measure passes this test if the following question is answered in the affirmative: *"if all 50 states enacted the challenged rule, would interstate commerce bear a burden that purely domestic commerce would not also bear?"*[266] Accordingly, *"a state tax must be structured so that if every state were to impose an identical tax, interstate commerce would fare no worse than intrastate commerce."*[267]

The 'internal consistency test' in US constitutional law is identical to the test in this study and demonstrates the 'internal consistency' of subjecting taxpayers with a taxable presence in a taxing state to unlimited taxation granting double tax relief in the form of the Dutch-style 'tax exemption' method.

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

[265] United States Supreme Court, *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983), and, e.g., United States Supreme Court, *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995).

[266] See Ruth Mason, 'Made in America for European Tax: The Internal Consistency Test', 49 *Boston College Law Review* 1277 (2008), at 1283.

[267] See Walter Hellerstein, 'Is Internal Consistency Dead?: Reflections on an Evolving Commerce Clause Restraint on State Taxation', 61 *Tax Law Review* 1 (2007-2008), at 1. See also the prequel to this article, Walter Hellerstein, 'Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation', 87 *Michigan Law Review* 139 (1988-1989).

3.3.2.4 Disregarding the effects at the other side of the tax border to demonstrate the presence or absence of an obstacle in an international tax system of a state

Accordingly, in assessing the internal consistency of the advocated approach, the analyses undertaken disregard the tax effects at the other side of the tax border.[268] That is, as disparities are assumed absent. The possibility of effectively cancelling out an obstacle at one side of the tax border by means of a reversed obstacle imposed at the other side at the tax border is ignored in this analysis. Indeed, no distortion would arise for the taxpayer if the other country at the opposite side of the border would unilaterally 'fix' the problem imposed at the one side of the border.[269-270]

In this study the position is taken that the characteristics of the international tax system of a state under review indicating the presence or the absence of an obstacle should be tested on their individual merits. That is to say, without looking at the tax effects on the other side of the tax border for the reasons given below. Indeed, it may be argued that the distorting tax treatment unilaterally imposed, for instance by an European Union Member State, may pass muster under primary European Union law if one were to consider the tax effects abroad as well.

It is true that European Union case law provides examples of cases in which the Court of Justice made the compatibility or incompatibility of a European Union Member State's tax measure with the fundamental freedom rights dependent on the tax effects in another European Union Member State.[271] Having said this, it is worth noting that other examples are available as well in which the Court of Justice does not do so.[272] Regardless of the doctrinal confusion that may arise as a consequence of this, some scholars observed that the Court of Justice applies an 'always somewhere approach', on the basis of which, e.g., the unilateral denial by an European Union Member State of a horizontal cross-border loss set-off otherwise available in a pure domestic scenario may be justified if some other country allows vertical loss set-off.[273] Others, e.g., Advocate General Kokott in her opinion in *Philips Electronics*, and particularly C-123/11 (*A Oy*), conversely, argue that one should ignore whatever happens in the tax system abroad.

Regardless of what the Court of Justice observed in its case law in this respect, it is – in the style of Walter Hellerstein – undesirable to construct a rule the operation of which depends on the present configuration of the tax laws of the other nation states.[274] Such an approach

[268] The approach has been taken identically in Maarten F. de Wilde, 'Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy', 38 *Intertax* 281 (2010), Maarten F. de Wilde, 'A Step towards a Fair Corporate Taxation of Groups in the Emerging Global Market', 39 *Intertax* 62 (2011), Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010), 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, 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, 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, as well as Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55.

[269] See e.g., Court of Justice, C-379/05 (*Amurta*).

[270] The following paragraphs have been drawn from Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55.

[271] See e.g. Court of Justice, case C-385/00 (*De Groot)* – on the tax treatment of personal allowances – and *Marks & Spencer II*, case C-446/03 – on the tax treatment of cross-border losses. See also Court of Justice, C-379/05 (*Amurta* where such an effect is referred to as 'neutralization'.

[272] Regarding cross-border losses, reference can be made in this respect to both 'home state cases', e.g., (implicitly) Court of Justice, case C-337/08 (*X Holding* and (also implicitly) C-414/06 (*Lidl*), as well as a 'host state case', i.e., (explicitly) C‑18/11 (*Philips Electronics*).

[273] The approach has originally been stated by Peter Wattel; see his comments on Court of Justice, case C-446/03 (*Marks & Spencer II*) in the Dutch tax literature (Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 2006/72. See also B.J.M Terra et al, *European Tax Law* (2012), at 465-467.

[274] See Walter Hellerstein, 'Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation', 87 *Michigan Law Review* 139 (1988-1989), at 170.

would make the absence or presence of an obstacle dependent on the shifting complexities of the international tax systems of nation states worldwide. Translated into European Union law, such an analysis would render the compatibility with European Union law of the tax laws of the European Union Member States dependent on the shifting complexities of the tax systems of the current twenty eight tax sovereign Member States. The compatibility or incompatibility with European Union law of the taxes imposed on an individual taxpayer would depend on the other European Union Member State in which it operates.

Such an approach would encroach on the sovereign rights of nation states to tax corporate earnings. Which hierarchically equal sovereign state should step back in a particular case to resolve the obstacle imposed. 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-neighbor European Union Member State tax policies with the Member State tax collections depending on who won the race to the taxpayer's door.''[275-276]

3.4 The operation of the Dutch double tax relief mechanism explained

3.4.1 The Dutch double tax relief mechanism's operation in general

3.4.1.1 Two-step approach akin to second limitation in common ordinary credit method

In this section first some words are devoted to the general mechanics of the double tax relief methodology as it currently applies to resident taxpayers individuals in the Netherlands. Please keep in mind that it is the double tax relief methodology itself that is the subject of analysis, i.e., on a stand-alone basis rather than the legal context within which it currently applies in the Dutch international tax system.

To demonstrate the operation of the combination of unlimited tax liability and Dutch-style double tax relief, the methodology is described in general terms first in section 4.1.2 of this chapter. The operation of the methodology is subsequently explained on the basis of scenarios identifying certain 'problem areas'. These scenarios deal with:

(1) cross-border business losses – section 3.4.2;
(2) intra-firm modes of transfer – section 3.4.3, and;
(3) currency exchange results – section 3.4.4.

The operation of the system is addressed in a default scenario, the 'Base Case', referring to a hypothetical corporate taxpayer 'Ben Johnson Dinghy Selling Company'. In the process, where relevant or convenient, general references will be made for comparison and illustration purposes to the distortive obstacles under the application of the export neutrality promoting tax credit mechanism and the import neutrality promoting base exemption mechanism.

Secondly, the overall effects under the application of the advocated approach will be assessed hereunder in section 5 of this chapter – i.e., the 'unlimited tax liability of corporate taxpayers with domestic sources of income and double tax relief under the Dutch-style 'tax exemption' mechanism'. The equitable and efficient properties of the advocated approach will be demonstrated by means of the thought experiment as drawn from US constitutional law referred to as the internal consistency test in the above paragraphs.

[275] See for the exact same argument on the constitutionality of US state taxes – Walter Hellerstein, 'Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation', 87 *Michigan Law Review* 139 (1988-1989), at 170. See further, Walter Hellerstein, 'Is Internal Consistency Dead?: Reflections on an Evolving Commerce Clause Restraint on State Taxation', 61 *Tax Law Review* 1 (2007-2008).
[276] The above paragraphs as said have been drawn from Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55.

The objective of the exercise is to identify the tax burdens imposed in a cross-border context, to compare it with the tax burdens in the equivalent domestic environment. If the difference in tax burdens is nil the equality and tax neutrality, and hence non-distortive properties of the system, would have been proven. As will be shown, the advocated approach achieves that objective by demonstrating its equitable and efficient properties.

Dutch-style double tax relief method effectively operates as a credit mechanism

The double tax relief mechanism for active income from foreign sources as currently applied in the Netherlands is commonly referred to as the 'tax exemption with progression method' in the international tax literature.[277] It is commonly explained in the literature as a base exemption mechanism under which 'the foreign source income is initially included in the taxpayer's income for the limited purpose of determining the average tax rate that taxpayer would pay if the foreign income would be taxable'. Subsequently, it is generally said that the 'average rate is then used to compute the actual tax due on the taxpayer's domestic source income'. This, unfortunately, is a mistaken understanding of the Dutch juridical double tax relief mechanism. Also the Court of Justice shows evidence, e.g., in the *X Holding* case that it does not fully understand the mechanism's operation.[278] The Dutch-style tax exemption with progression methods does not operate in such a manner, as it does not exempt foreign source income from the tax base. It simply does not operate as a base exemption; essentially it is a credit.

Despite the commonly used term 'tax exemption' – which, notably, is also the clouded Dutch term '*belastingvrijstelling*', a term that literally translates into English as 'tax exemption' presumably thereby triggering the confusion –, the double tax relief mechanism conceptually operates as a credit.[279] Even in Dutch tax literature the term exemption is used, typically without the mechanism being recognized as a credit as well.

But the credit would equal the amount of domestic tax attributable to foreign income

However, contrary to the tax credit mechanisms that are commonly applied in international taxation, it is not the tax levied abroad that is credited against the domestic tax imposed on the foreign income. It is a credit for the domestic income tax attributable to the foreign source income items. It is the domestic tax on the foreign income that is credited against the tax that is levied on the taxpayer's worldwide income – rather than a credit for the foreign tax as is typically the case under a tax credit mechanism. The double tax relief is accordingly calculated without looking at the actual foreign tax paid, i.e., as the system seeks for internal consistency.

Crediting the domestic tax attributable to the foreign income in two steps

Under its double tax convention network, the Netherlands reserves the right to include foreign source income items, both positive and negative, in the domestic tax base for the purpose of taxing Dutch resident taxpayers – the 'tax base reservation'. First, foreign source income items are included in the resident taxpayer's worldwide tax base; *'Step 1 – In'*. Next, double tax relief is provided with respect to the foreign source income items that have been included in the Dutch worldwide tax base under Dutch tax law (the 'tax base requirement'); *'Step 2 – Out'*. The Dutch tax payable is subsequently determined by crediting the Dutch tax that is attributable to the foreign source income items against the Dutch tax as calculated by reference to the respective taxpayer's worldwide income.

[277] See Brian J. Arnold et al, *International Tax Primer* (2002), at 33-34.
[278] See Court of Justice case C-337/08 (*X Holding*) and the comments thereon by Dennis M. Weber, 'Refusal of advantages of a cross-border tax consolidation in some situations an unjustified restriction of the freedom of establishment', *Highlights and Insights on European Taxation* 2010/1.6. See also Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010).
[279] See for some details, Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international (*2011), at sections 1 and 2.

The mechanism that accordingly applies in the Netherlands to resident taxpayers with respect to foreign income from active sources, as said, is conceptually a credit for domestic tax attributable to the foreign income. In its operation, the methodology works in a manner akin to the second limitation as commonly applied in international taxation under an ordinary credit mechanism. However, in this case, the second limitation operates on a stand-alone basis. That is without making reference to the foreign taxes levied – as is typically the case under the first limitation in the common ordinary credit mechanism. At the end of the day, the taxpayers pay tax on the domestically sourced fraction of their worldwide income.

3.4.1.2 Some numerical exercises: 'Ben Johnson Dinghy Selling Company'

The 'base case' scenario

The operation of the Dutch-style double tax relief methodology can be best explained by means of some numerical examples. The following subsection explores the effects by assessing the application of the double tax relief mechanism with regards to a hypothesized corporate taxpayer 'Ben Johnson Dinghy Selling Company'.

The business income of the Dutch resident taxpayer 'Ben Johnson Dinghy Selling Company', hereinafter 'Johnson', from its Dutch source A, for instance a branch situated within Dutch territory, adds up to €140,000 (positive) in year 1. Johnson's business income from foreign source B, for instance a branch situated in *State X*, for instance Belgium, adds up to €60,000 (positive). Let us assume that Johnson thereby derives business income in Belgium through a permanent establishment situated within Belgian territory. The territorial allocation of business income occurs in accordance with OECD concepts and principles. It is assumed that Johnson is eligible for double tax relief under the Dutch-style double tax relief methodology for active foreign source income. Johnson's worldwide income equals €200,000.

Notably, it is assumed that Johnson is a single tax entity for corporate tax purposes. The effects of the separate entity approach and whether it operates adequately is addressed in Chapter 4. Furthermore, the tax base is calculated by reference to that under a conventional corporation tax typically applied internationally, i.e., a tax on the nominal returns on equity. The question of whether such an approach is adequate is discussed in Chapter 5. The issue of profit allocation is further discussed in Chapter 6.

My purpose in this section is to illustrate the effects of the double tax relief mechanism itself. To detach the mechanism's operation from its legal context, i.e., the Dutch international tax system. In the following subsections the Netherlands is predominantly referred to as the 'home state' and Belgium is referred to as the 'host state'. Some distance is accordingly created to enable the assessment of the mechanics and its operation without clouding things by the operation of local tax law.

The base case in figures (before tax):

Fig. 1. Balance Sheet "branch A" on 1/1 (i.e., start of tax year)

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

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

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

Fig. 3. Balance Sheet "branch A" on 12/31 (i.e., end of tax year)

Balance Sheet "branch A" on 12/31

	Debit		*Credit*
Assets	€3,140,000	Equity Liabilities	€2,140,000 €1,000,000
On balance	€3,140,000	On balance	€3,140,000

Fig. 4. Balance Sheet "branch B" on 1/1

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

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

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

Fig. 6. Balance Sheet "branch B" on 12/31

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

Let us further suppose that the corporate income tax rate in the host state Belgium equals a linear 18%; the home state the Netherlands applies a progressive tax rate in its profit tax system. And let us assume that the tax brackets in the home state are arranged as follows:

Fig. 7. Tax Brackets

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

Determining Johnson's tax liability; taxing the fraction

Johnson's tax liability is determined, as said, in two steps. First, the home state tax on Johnson's worldwide income is calculated. The home state tax on Johnson's worldwide income of €200,000 amounts to €5,000[280] + €10,000[281] + €25,000[282] = €40,000. Second, the double tax relief is calculated by reference to the home state tax attributable to Johnson's foreign income. The functionally separate entity approach in the applicable double tax convention is equivalent of Article 7 OECD Model Tax Convention. This functionally separate entity approach is taken as a given. The double tax relief is calculated by reference to the following *fraction*: foreign income (€60,000) / worldwide income (€200,000)* home state tax on worldwide income (€40,000). The double tax relief therefore amounts to €12,000 in the example.[283] The tax payable in the home state accordingly amounts to €40,000 - €12,000 = €28,000. This equals an average effective tax rate in the home state of 20% on the home state share of the international tax pie of €140,000.

In this way, the progressiveness in the home state tax rate structure is preserved. This explains the element 'with progression' in the Dutch-style double tax relief mechanism's wording. Please note that the amount of tax payable in the host state – €10,800[284] – regarding Johnson's foreign income of €60,000 is ignored for the purpose of calculating the double tax relief in the home state.

[280] 10% * 50,000 = 5,000.
[281] 20% * 50,000 = 10,000.
[282] 25% * 100,000 = 25,000.
[283] 60,000 / 200,000 * 40,000 = 12,000.
[284] 18% * 60,000 = 10,800.

Import neutrality promoting base exemption is distortive

The application of a production factor export distorting but import neutrality promoting base exemption for foreign income in this case would have led to a tax payable in the home state of €25,000 (tax payable on Dutch-sourced income of €140,000: 10% * 50,000 + 20% * 50,000 + 25% * 40,000). This would have entailed a 'dislocation' or, more accurately put, an unjustified unequal treatment by the home state, i.e., the Netherlands in the current example. The home state would favor Johnson over its competitors that decided to stay at home and not take their business across tax borders in this case.

This effect is caused by the income split. The tax benefit unilaterally granted to Johnson would be €3,000 (tax payable on worldwide income less double tax relief of 28,000 – tax payable on Dutch sourced income in the case the import neutral base exemption 25,000). This 'what-if-import neutrality-approach' illustrates the absence of export neutrality in this case in an import neutrality promoting territorial tax system. The numbers show that import neutrality promoting international tax systems distort outbound investment.

Export neutrality promoting tax credit is distortive

Furthermore, the application of a production factor import distorting but export neutrality promoting ordinary credit for foreign tax would have resulted in a tax payable in the home state of €29,200 (Dutch tax of €40,000 – Belgian tax of 10,800). This would mean a competitive disadvantage for taxpayer Johnson in Belgium in comparison with Johnson's local, i.e., Belgian, competitors in the host state who are merely subject to the 18% linear tax rate. In such a 'what-if-export-neutrality-approach', the home state, the Netherlands in the current example, would have discriminated against Johnson vis-à-vis its competitors in the host state – Belgium in the current example.

In this situation the unilaterally imposed tax disadvantage amounts to €1,200 (€29,200 - €28,000). To derive an equal amount of after-tax profits, Johnson would have needed to increase the prices for his dinghies sold in the host state. That might have caused Johnson to rapidly run out of business there. Knowing this, Johnson, might have even considered not to engage into business activities in Belgium in the first place. This 'what-if-export-neutrality-scenario' illustrates the absence of import neutrality in an export neutrality promoting tax credit system. The example also neatly illustrates the distortive features of an export neutrality promoting tax credit system, which brought Klaus Vogel to argue that the use of such a system entails the introduction of unilaterally imposed obstacles in the system.[285] The example shows that export neutrality promoting international tax systems distort inbound investment.

3.4.2 Foreign and domestic source losses; cross-border loss set-off

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

It follows from the adoption of the 'tax base reservation' in the double tax convention network of the Netherlands that resident taxpayers may include negative income items from foreign sources in their domestic tax base. Hence, the Netherlands as home state allows resident taxpayers to offset foreign source losses/profits against domestic source profits/losses horizontally. In the case of resident taxpayers suffering foreign or domestic source losses, single taxation of cross-border business income is subsequently achieved through the application of the so-called 'recapture of foreign losses mechanism' and the 'carry forward of foreign profits mechanism'.

The single tax principle is thereby acknowledged. This is the effect of the Dutch-style double tax relief mechanism that the Court of Justice, unfortunately, failed to fully appreciate in the *X*

[285] See Klaus Vogel, 'Which Method Should the European Community Adopt for the Avoidance of Double Taxation?', 56 *Bulletin for International Taxation* 4 (2002).

Holding case.[286] The operation of the 'recapture of foreign losses mechanism' and the 'carry forward of foreign profits mechanism', again, are best explained by way of numerical examples.

3.4.2.2 The recapture of foreign losses mechanism

Exploring some alternatives to the 'Base Case'; foreign source losses

Suppose that, all other things being equal to the 'Base Case', taxpayer Johnson resident in the home state suffers a loss from its activities carried on through its branch B in host state Belgium in the amount of €60,000 in year 1. Johnson's taxable base amounts to €80,000, as the foreign loss is taken into account to calculate the home state tax base – horizontal loss compensation.[287] Consequently, the tax payable in the home state amounts to €11,000 (i.e., 5,000 + 6,000).[288] No double tax relief will be given that year as taxpayer Johnson suffered a loss abroad. Johnson receives an administrative notice from the tax inspectorate that the loss of €60,000 is recaptured as soon as Johnson manages to derive positive income from its host state branch B in a following year.

Import neutrality promoting base exemption would prove distortive

If the home state had a production factor exports distorting but import neutrality promoting base exemption for foreign income, the tax payable in the home state would amount to €25,000 (10% * 50,000 + 20% * 50,000 + 25% * 40,000) on an income of €140,000. This would have led to a 'dislocation' disadvantaging taxpayer Johnson in comparison with his competitors that decided to stay at home and not take their business across the tax borders, i.e., in the Netherlands in the current example .

This would have been caused by the then non-deductibility of the negative income items realized through the branch B in the host state Belgium. The unilaterally imposed tax disadvantage under such a 'what-if-import-neutrality-approach' would equal €14,000 (25,000 – 11,000), an increase of the tax burden by a factor of roughly 2.28 (2.28 * 11,000 ≈ 25,000). Also this example shows the absence of neutrality – in this case export neutrality – under an import neutrality promoting territorial tax system. Import neutrality promoting tax systems distort outbound investment.

Back to the Dutch-style double tax relief method

Let us return to the application of the Dutch-style double tax relief method. Let us suppose that, in year 2, taxpayer Johnson manages to derive a profit from of its activities carried on through its branch B in the host state of €80,000, all other things being equal to the 'Base Case'. In year 2, Johnson's worldwide income is consequently €220,000.[289]

As said, the double tax relief is determined in two steps. First, the home state tax on Johnson's worldwide income is calculated at €5,000 + €10,000 + €30,000[290] = €45,000. Second, the double tax relief is calculated. The year 1 loss of €60,000 is recaptured in year 2 under the 'recapture of foreign losses mechanism'. Technically, this entails that the numerator in the fraction decreases to 20,000 (i.e., 80,000 – 60,000). The reduction of the numerator in the fraction leads to a reduction of the double tax relief provided – and consequently

[286] See Court of Justice case C-337/08 (*X Holding*) in which the court, unfortunately mistakenly, recognized double dip risks and arbitrary shifting of tax bases across taxing jurisdictions under the application of the Dutch juridical double tax relief methodology. See for comments on the court's ruling in the *X Holding* case, Dennis M. Weber, 'Refusal of advantages of a cross-border tax consolidation in some situations an unjustified restriction of the freedom of establishment', *Highlights and Insights on European Taxation* 2010/1.6, and Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010).
[287] 140,000 – 60,000 = 80,000.
[288] 5,000 + 20% * 30,000 = 11,000.
[289] 140,000 + 80,000 = 220,000.
[290] 25% * 120,000 = 30,000.

increases tax payable in the home state. The double tax relief granted in year 2 amounts to €4,090.91.[291] The tax payable in the home state in year 2 therefore amounts to €40,909.09.[292]

This mechanism accordingly ensures that the year 1 loss is tax-deductible when actually suffered, yet only taken into account once instead of twice. Single taxation is guaranteed and the single tax principle is respected. The host state sovereign tax entitlements regarding the income items that are sourced in the host state are respected. Host state tax implications such as the availability of local loss set-off possibilities are ignored. As said this is done to keep the assessment analytically sound. This is regarded as a sovereign tax matter of the host state, i.e., Belgium in the current example. Notably, it has been argued in the literature that cross-border loss offset would mitigate tax competition.[293]

3.4.2.3 The carry forward of foreign profits mechanism; domestic source losses

Let us now suppose that, all other things being equal to the 'Base Case', the taxpayer Johnson resident in the home state suffers a loss from its activities carried on through its branch A in the home state of €140,000 in year 1. As this domestic loss is taken into account for the purpose of calculating the domestic tax base, i.e., 'horizontal loss compensation', Johnson's taxable base consequently amounts to €80,000 negative.[294] As a result of this, the tax payable in the home state amounts to nil. No relief is granted as the tax payable in the home state is already nil and no cash is refunded. Contrary to the European Union value added tax, for example, cash refunds are generally unavailable in corporate taxation – see further Chapter 5. Johnson receives an administrative notice from the tax inspectorate that the foreign profit of €60,000 is carried forward to a following year in which Johnson manages to derive positive income from its activities carried on through its domestic branch A.

Now let us suppose that, in year 2, taxpayer Johnson realizes a profit generated in its domestic source a) of €200,000, all other things being equal to the 'Base Case'. In year 2, Johnson's worldwide income is consequently €260,000.[295] Again, the home state tax relief is determined in two steps. First, the home state tax on Johnson's worldwide income is calculated at €5,000 + €10,000 + €40,000[296] = €55,000. Second, the amount of double tax relief is calculated. The year 1 profit of €60,000 derived from the activities carried on through branch B in the host state is carried forward to year 2 under the 'carry forward of foreign profits mechanism'. Technically, this entails that the numerator in the fraction increases to 120,000 (i.e. 60,000 + 60,000). The increase in the numerator in the fraction leads to an increase of double tax relief given that year – and as a result to a decrease in tax payable in the home state. The double tax relief provided for in year 2 amounts to €25,384.62.[297] The tax payable in the home state in year 2 accordingly amounts to €29,615.38.[298]

This mechanism accordingly ensures that the year 1 profit realized abroad does not diminish for double tax relief purposes but, instead, is taken into account as a profit eligible for double tax relief in year 2. Accordingly, Johnson's profits are taken into account once – rather than not at all. Single taxation is guaranteed. Again, the sovereign tax entitlements of the host state regarding the proceeds derived from the business activities carried on through branch B are respected. The host state tax implications are ignored, as the system seeks internal consistency.

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[291] (80,000 - 60,000) / 220,000 * 45,000 = 4,090.91.
[292] 45,000 - 4,090 = 40,909,09.
[293] See Marcel Gérard and Joann Weiner, 'Cross Border Loss Offset and Formulary Apportionment: How do they affect multijurisdictional firm investment spending and interjurisdictional tax competition?', *CESifo Working Paper* 2003:1004, at 21.
[294] 60,000 - 140,000 = <80,000>.
[295] 200,000 + 60,000 = 260,000. Notably, vertical loss set-off is disregarded. Please assume that the year 1 loss of 80,000 is carried back for vertical loss-compensation purposes.
[296] 25% * 160,000 = 40,000.
[297] (60,000 + 60,000) / 260,000 * 55,000 = 25,384.62.
[298] 55,000 – 25,384.62 = 29,615.38.

3.4.3 Notional services provided, notional supplies of goods (stock and capital assets)

3.4.3.1 Intra-firm transactions

Profit attribution in international taxation

Before getting into the operation of the Dutch-style tax exemption method in respect of intra-firm transactions, I would like to make some remarks on profit allocation under current international tax concepts (see fig. 8). The question of whether these concepts operate properly, as said, is addressed separately in Chapter 6.

Fig. 8. Profit attribution in international taxation

In accordance with the approaches that are commonly made use of in international taxation, the allocation of a taxpayer's business income to tax jurisdictions would occur in two steps.[299]

1. *Step 1 – nexus.* To be able to allocate a resident taxpayer's business income to a state other than its residence state, that taxpayer's economic presence in that other state must exceed a certain minimum threshold. A qualitative criterion has been chosen for this purpose. Turnover is not sufficient. A physical presence is required such as a store similar to taxpayer Johnson's branch B in host state Belgium. The threshold referred to is the permanent establishment, i.e., a fixed place of business through which the taxpayer carries on its business activities in that other state.

2. *Step 2 – allocation.* Not until the permanent establishment threshold is met, business income may be attributed to that permanent establishment, and with that to the other state, which may subsequently tax the income derived by that non-resident taxpayer.

The international tax regime contains two consecutive fictions for profit attribution purposes. These are commonly referred to as the 'two-step analysis'. [300]

1. *Two-step analysis, step 1*. The first fiction, or step, is that the permanent establishment, e.g. Johnson's branch B in the home state, is deemed to be an enterprise that is functionally separate from the taxpayer's remaining activities, i.e., the 'head office', e.g. Johnson's branch A. This fiction, as already addressed on some earlier occasions, is commonly referred to as the 'functionally separate entity approach'.[301] As a consequence of that, the allocation of the production factors of capital and labor by the taxpayer within a cross-border context may result into the recognition for profit allocation purposes not only of transactions with third parties, i.e., customers and suppliers, but also the recognition of 'internal dealings' between the permanent establishment, branch B, in the host state or the source state in international tax terminology, and the taxpayer's head office, branch A in the home state or the residence state in international tax terminology. Internal dealings recognized for profit allocation purposes may comprise intra-firm provisions of services, supplies of goods, or capital asset transfers between a head office and a permanent establishment, for instance between Johnson's branches a) and b). Intra-firm transactions are recognized for profit allocation purposes on the basis of a so-called 'functional and factual analysis'. The analysis seeks to identify in which location the taxpayer's workers are actually working, (functions performed), or the location in which these workers employ the taxpayer's property (assets used), as well as the location in which the taxpayer is accordingly subject to the economic risks involving its business activities (risks assumed).[302]

2. *Two-step analysis, step* 2. A price must be set for intra-firm transactions that are recognized or

[299] See for some details, Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international (*2011), at section 2.1.2. A similar profit allocation methodology applies to affiliated corporate bodies.
[300] See OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.
[301] The functionally separate can be found in Article 7 of the OECD Model Tax Convention.
[302] See OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

notionally recognized for tax purposes as if the permanent establishment, branch B, the head office, and branch A, are mutually independent business enterprises.[303] This is the second fiction, or second step in the 'two-step analysis', referred to as said, as the arm's length principle. The remuneration for the intra-firm transaction, or the 'transfer price', is identified on the basis of a so-called 'third party comparability analysis'. The analysis seeks to identify what independent, third parties would do under comparable economic circumstances – the 'benchmark study').

Business income that cannot be attributed to the host state, i.e., Belgium in the current example, by means of the aforementioned procedure, is attributed to the taxpayer's, i.e., Johnson's home state, i.e., the Netherlands in the current example.

The purpose of this profit allocation procedure, at the end of the day, is to allocate business income to the jurisdiction in which the taxpayer actually employs its production factors of capital (property, assets) and labor (workers).[304] Accordingly, it is sought to allocate income tax to tax jurisdictions on the basis of origin-based allocation factors,[305] echoing the supply side of economics.[306] This being said, the issue of profit allocation is extensively discussed in Chapter 6.

Intra-firm, intra-entity, intra-taxpayer notional dealings are disregarded when calculating worldwide income

Under Dutch international tax law, the notional proceeds from notional, intra-firm, transactions are not recognized for resident taxpayers' worldwide income calculation purposes. Due to the operation of the tax base reservation, a Dutch resident taxpayer's worldwide income does not increase or decrease as a consequence of the recognition of internal dealings.

This makes sense. Profit allocation in international taxation is built on fictions; a world of smoke and mirrors as it is referred to in Chapter 6. In reality, however, no profit has been made upon the supply of an intra-firm service. All happens within the context of a single taxpayer. The only thing that actually occurs is that the taxpayer employs its production factors, its workers and assets, in a cross-tax border context within the emerging global market. No money is made while doing that. The identification of internal dealings merely serves the purpose of the allocation of profits actually made to tax jurisdictions under an origin-based, supply side, allocation methodology.

Intra-firm, intra-entity, intra-taxpayer notional dealings are regarded when calculating double tax relief

[303] See *OECD Transfer Pricing Guidelines*, OECD, Paris, 2010.
[304] See Richard J. Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World', 2 *World Tax Journal* 291 (2010), at 310, Klaus Vogel, '"State of Residence" may as well be "State of Source" – There is No Contradiction', 59 *Bulletin for International Taxation* 420 (2005), at 420-422 and Maarten F. de Wilde, 'A Step towards a Fair Corporate Taxation of Groups in the Emerging Global Market', 39 *Intertax* 62 (2011).
[305] It should be noted that an opposite approach is adopted under value added tax ('VAT') systems, such as the VAT system as applied in the European Union. In VAT, the value added is allocated to the geographic location, taxing jurisdiction, where the goods supplied and services rendered are consumed; the destination principle. The quest for the place of taxation adheres to the demand side of economics. As it is unfeasible to determine the place of consumption, the place of taxation is typically found by means of proxies, such as 'place of service rules' and 'place of supply rules' as often found in VAT systems, including the European Union VAT. See further Rebecca Millar, 'Echoes of Source and Residence in VAT Jurisdictional Rules', *Sydney Law School Research Paper* 2009:44, Rebecca Millar, 'Intentional and Unintentional Double Non-Taxation Issues in VAT', *Sydney Law School Research Paper* 2009:45. Worth noting is that the sharing mechanism as envisaged by the CCCTB Working Group seeks an intermediary approach between origin based, supply side, and destination based, demand side, allocation factors. The envisaged key to share the tax base within the European Union, 'formulary apportionment', contains a combination of factors aiming at both the supply side ('payroll', 'assets') and the demand side ('sales') of economics. See further, Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9 . See also Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8.This subject is further discussed in Chapter 6.
[306] See for a comparison Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9. See also Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 41-45.

Under Dutch international tax law, internal dealings are however recognized for double tax relief calculation purposes. Notional profits are acknowledged to calculate the double tax relief under the Dutch-style tax exemption method. Accordingly, the amount of relief granted is affected by the presence of intra-firm dealings. That is, to acknowledge common profit attribution methodologies in international taxation.

If it is assumed that the applied profit allocation methodology entails a fair allocation of tax base amongst tax jurisdictions – which it is for now; this issue is further dealt with in Chapter 6 – the application of the Dutch-style tax exemption method entails a fair allocation of tax amongst these tax jurisdictions.

In cases where *notional business income arises in the home state*, i.e., the Netherlands in the current example, the amount of double tax relief provided reduces to the extent that positive amounts of notional income have been derived in the home state from internal dealings. The amount of double tax relief provided increases to the extent that negative amounts of notional income have been derived in the home state from internal dealings.

Notional proceeds from internal dealings arise in the home state when resident taxpayers employ their workers (labor) and property (capital) in the home state for the benefit of their foreign business activities. This is the case when the taxpayer's workers actually perform their functions within the territories of the home state and when the taxpayer's assets are functionally utilized by these workers within the territories of the home state.[307]

In cases where *notional business income arises in the host state*, i.e., Belgium in the current example, the double tax relief methodology applies in an opposite manner. The amount of double tax relief provided increases to the extent that positive amounts of notional income have been derived in the host state from internal dealings. The amount of double tax relief provided decreases to the extent that negative amounts of notional income have been derived in the host state from the internal dealings undertaken.

Notional proceeds from internal dealings arise abroad when resident taxpayers employ their workers (labor) and property (capital) in the host state for the benefit of their business activities in the home state. This is the case when the resident taxpayer's workers actually perform their activities within the geographic territories of the host state and when the resident taxpayer's assets are functionally used within the territories of the host state.

In the event that production factors are transferred from the 'head office' in the home state to the 'permanent establishment' in the host state, a 'split is made for double tax relief calculation purposes. It particularly concerns the transfer of property on a company's balance sheets to a foreign country; the capital factor – i.e., as the factor labor is not capitalized on a company's balance sheets. Under commonly applied international profit allocation concepts, the property transferred is calculated at fair value upon its transfer abroad; i.e., the internal dealing that is recognized for geographic profit attribution purposes.

The scenarios are further explored by means of numerical examples in sections 3.4.3.2 through 3.4.3.4 hereunder – 'effects under current Dutch international tax law' – and 3.5.3.3 – 'effects under the advocated approach'. For this purpose, reference is made to both intra-firm provisions of services and intra-firm supplies of goods. Regarding the latter, a further reference is made to intra-firm transfers of stock and intra-firm transfers of capital assets.

3.4.3.2 Intra-firm provisions of services

[307] Difficulties arise in cases where it concerns taxpayers employing mobile capital (financial and intangible assets). These items can easily be transferred across taxing jurisdictions legally due to their volatile characteristics, and relocated for instance into a low-taxing jurisdiction. In consequence, the adoption of origin based allocation factors has the consequence of enabling tax base transfers across taxing jurisdictions just as easily. This reality lies at the heart of the international profit allocation issue.

Outward bound notional services rendered

The operation of the double tax relief mechanism in these cases again may be best explained through numerical examples. Let us, therefore, return to our taxpayer Johnson in the 'Base Case'. The business income derived from Johnson's home state branch A adds up to €140,000. Johnson's business income derived from its branch B in host state Belgium adds up to €60,000. Consequently Johnson's worldwide income again is €200,000. Let us suppose, in addition, that one of taxpayer Johnson's workers in branch A renders an internal service such as a notional financial service or a service under a leasehold, or license arrangement for the benefit of the business activities carried on through branch B. The dealing is recognized as an internal dealing upon a functional and factual analysis for which an at arm's length consideration should be taken into account for corporate tax purposes. Let us further suppose that the fair market value of the service rendered equals to €15,000, an amount determined under the arm's length principle – i.e., an amount, which, at this time, for argument's sake, is assumed to be determined conceptually in an adequate manner.

Under the Dutch-style double tax relief methodology, Johnson's worldwide income does not alter as a result of the intra-firm service rendering. That is as an effect caused by the operation of the tax base reservation in the Dutch double tax convention network. It continues to amount to €200,000. This is conceptually sound as taxpayer Johnson has not actually earned a profit upon the supply of the internal service by its worker in branch A. Johnson does not actually make money at that time.

Import neutrality promoting base exemption would prove distortive

Notably, would the home state have applied an import neutrality promoting base exemption mechanism, the intra-firm supply of services would have led to a taxable event at this time, resulting in corporate tax due on the notional, fictitious item of income. The levy of such an exit tax at that time is conceptually unsound as it is distortive because the taxpayer has not actually derived income at that time. In fact no profit has been made. Notional income is not actual income, but fictitious 'smoke and mirror' income.

Back to the Dutch-style double tax relief method

Let us return to the operation of the Dutch-style double tax relief method. The home state tax on Johnson's worldwide income continues to amount to €5,000 + €10,000 + €25,000 = €40,000. The tax is imposed at an average effective tax rate of 20%.[308] Subsequently, the double tax relief is calculated. The amount of relief alters in comparison with the equivalent under the 'Base Case' since an intra-firm dealing, the intra-firm service rendered by Johnson's worker, has been recognized for double tax relief purposes under the functionally separate entity approach. Contrary to the 'Base Case' the application of the fraction means that the double tax relief amounts to €9,000[309] instead of €12,000.[310]

This makes sense in terms of the allocation of business income under origin based, supply side allocation factors – as is the case in international taxation today. Viz., Johnson employs its production factor labor, i.e., its home state worker, for the benefit of its activities abroad, i.e., in host state Belgium. In effect, as a consequence of the notional remuneration 'paid' by the host state to the home state, i.e., the Netherlands in return for the notional service rendered in the home state for the benefit of Johnson's activities in the host state, the tax base is transferred from the host state to the home state. The tax payable in the home state amounts to €40,000 - €9,000 = €31,000 and equals an average effective tax rate in the home state of 20% on the home state share of the tax pie of €155,000, i.e., €140,000 + €15,000. The amount of relief that is granted regarding the host state, i.e., Belgian, share of the tax pie effectively equals 20% as well.[311]

[308] 40,000 / 200,000 * 100% = 20%.
[309] (60,000 – 15,000) / 200,000 * 40,000 = 9,000.
[310] 60,000 / 200,000 * 40,000 = 12,000.
[311] 9,000 / (60,000 – 15,000) * 100% = 20%.

Inward bound notional services rendered

Now let's look at the reverse situation and let us suppose that one of the workers in branch B renders the intra-firm service for the benefit of the business carried on through branch A. Under the double tax relief methodology, Johnson's worldwide income again does not alter in such a reversed scenario. The home state tax on Johnson's worldwide income accordingly continues to amount to €40,000, an average effective tax rate of 20%. Again the double tax relief, as subsequently calculated alters in comparison with the 'Base Case' since an intra-firm dealing has been recognized for double tax relief purposes. The double tax relief calculated alters in the exact opposite manner as described in the above paragraph. The application of the fraction results in a double tax relief in the amount of €15,000[312] instead of €12,000.

In terms of the allocation of business income under origin based supply side allocation factors, this makes sense. Viz., Johnson employs its production factor labor, i.e., its host state worker for the benefit of its activities in the home state. In effect, due the notional remuneration 'paid' in the home state to the host state in return for the notional service rendered in the host state for the benefit of Johnson's activities in the home state this entails a transfer of tax base from the home state to the host state. The tax payable in the home state accordingly amounts to €40,000 – €15,000 = €25,000. An amount of home state tax payable, which again entails an average effective tax rate in the home state of 20% on the home state share of the tax pie, is now calculated at €125,000, i.e., €140,000 – €15,000. The double tax relief provided with respect to the host state share of the tax pie effectively equals a 20% rate also.[313]

3.4.3.3 Intra-firm supplies of goods (stock transfers)

Outward bound notional stock transfers

Let us suppose that in addition, to all other things being equal to the 'Base Case' stock – a dinghy – has been produced through branch A to be sold on the market. Suppose that the manufacturing costs of the boat equal €5,000 and the wholesale value of the dinghy equals €12,000. Suppose that the good is transferred to branch B situated in the host state and suppose that the good, is sold through branch B on the market at a resale price of €20,000.

Under the double tax relief methodology, Johnson's income does not alter upon the intra-firm supply of goods from branch A to branch B. Again, this is caused by the operation of the tax base reservation. And again, this, in my view, is conceptually sound as taxpayer Johnson has not in fact derived a profit by just shipping the good abroad to its branch in the host state.

Import neutrality promoting base exemption would prove distortive

Notably, under an import neutrality promoting base exemption mechanism, the intra-firm supply of goods would have led to a taxable event at this time – the levy of an 'exit tax', resulting in corporate tax due. In my view, the levy of such a tax at this time is conceptually unsound, since it is distortive because the taxpayer has not actually derived income at that time. In fact no profit was made upon the transfer of the dinghy to the host state branch B.[314] So why pay tax?

Back to the Dutch-style double tax relief method

[312] (60,000 + 15,000) / 200,000 * 40,000 = 15,000.
[313] 15,000 / (60,000 + 15,000) * 100% = 20%.
[314] In cases falling within the confines of the Treaty on Functioning of the European Union, the levying of such a tax conceptually infringes upon the freedom of establishment. See Court of Justice, cases C-9/02 (*De Lasteyrie du Saillant*) and C-470/04 (*N.*). Contra, Court of Justice, cases C-250/95 (*Futura*), C-414/06 (*Lidl*) and C-337/08 (*X Holding*). See on the Court of Justices ambiguous approach on these matters, Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010). See also Dennis M. Weber, 'Refusal of advantages of a cross-border tax consolidation in some situations an unjustified restriction of the freedom of establishment', *Highlights and Insights on European Taxation* 2010/1.6.

Let us return to the application of the Dutch-style double tax relief method. Taxpayer Johnson first realizes the profit, calculated at €15,000 upon the sale of the good in the marketplace. At that time, Johnson's worldwide income amounts to €215,000, i.e., €200,000 + €15,000.[315] This makes sense as Johnson actually derives income upon the sale of the dinghy. At that time, the home state tax on Johnson's worldwide income amounts to €43,750,[316] which equals an average effective tax rate of 20.3%.[317] The profit of €15,000 needs to be split for this purpose between the home state and the host state as from an origin based profit allocation perspective value has been added in both jurisdictions.

In terms of the allocation of business income under origin based supply side allocation factors this makes sense. Viz., Johnson employs the combination of its production factors labor, i.e., its home state workers (wholesale activities) and host state workers (retail activities), and capital, i.e., the dinghy, for the benefit of its activities in both the home state and the host state. Due to a notional remuneration 'paid' in the host state to the home state in return for the notional supply of goods from the home state to host state, this entails a transfer of Johnson's worldwide tax base of €15,000 from the host state to the home state. The profit realized on the sale of the good at the market place attributable to branch A in the home state equals to €7,000.[318] The profit share attributable to branch B in the host state equals to €8,000.[319]

Under the double tax relief mechanism subsequently applied, the fraction equals to €13,837.21.[320] The tax payable in the home state accordingly amounts to €43,750 – €13,837.21 = €29,912.79. The amount of home state tax payable on the profit realized on the sale of the good that is attributable to branch A, i.e., €7,000, equals €1,424.42.[321] Consequently, the amount of home state tax payable thus determined equals to an average effective tax rate in the home state of 20.3% on the home state share of the tax pie calculated at €147,000 (i.e., €140,000 + €7,000[322]).[323] The amount of double tax relief provided with respect to the host state share of the tax pie effectively equals a 20.3% rate also.[324]

Inward bound notional stock transfers

Now imagine the *reverse situation* and suppose that the good is produced through branch B and subsequently transferred to branch A followed by a sale of the good in the marketplace. Again, Johnson's worldwide income does not alter upon the intra-firm supply of goods from branch B to branch A. Again, taxpayer Johnson first realizes the profit of €15,000 upon the sale of the good in the marketplace. Again, things result into an overall worldwide income of €215,000 producing a home state tax calculated at €43,750, i.e., an average effective tax rate of 20.3%. The profit of €15,000 needs to be split for this purpose between the host state and the home state as value has been added in both jurisdictions, at least, from an origin based perspective that is.

In terms of the allocation of business income under origin based, supply side allocation factors, this makes sense. Viz., Johnson employs the combination of its production factors labor, i.e., its home state workers (retail activities) and host state workers (wholesale activities), and capital, i.e., the dinghy, for the benefit of its activities in both the host state and the home state. Due to a notional remuneration 'paid' in the home state to the host state in return for the notional supply of goods from the host state to the home state Johnson's worldwide tax base is increased by €15,000 as a result of the transfer of this tax base from the home state to the host state, respectively The Netherlands and Belgium in the current

[315] The latter amount being calculated as 20,000 – 5,000 = 15,000.
[316] 10% * 50,000 + 20% * 50,000 + 25% * 115,000 (i.e. 100,000 + 15,000) = 43,750.
[317] 43,750 / 215,000 * 100% = 20.3%.
[318] 12,000 - 5,000 = 7,000.
[319] 20,000 - 12,000 = 8,000.
[320] (60,000 + 8,000) / (200,000 + 15,000) * 43,750 = 13,837.21.
[321] (7,000 / 15,000) * (43,750 / 215,000) * 15,000 = 1,424.42.
[322] (1,424.42 / 7,000) * 100% = 20.3%.
[323] 29,912.79 / 147,000 * 100% = 20.3%.
[324] 13,837.21 / (60,000 + 8,000) * 100% = 20.3%.

example. This time the profit realized on the sale of the good in the market place attributable to branch A equals €8,000.[325] The profit share attributable to branch B equals to €7,000.[326]

Under the double tax relief mechanism subsequently applied, the fraction equals to €13,633.72.[327] The tax payable in the home state accordingly amounts to €43,750 – €13,633.72 = €30,116.28. The amount of tax payable that can be attributed to the profit realized on the sale of the good that is attributable to branch A, i.e., €8,000, equals to €1,627.91.[328] Consequently, the amount of tax payable in the home state corresponds to an average effective tax rate in the home state of 20.3% on the home state share of the tax pie, which is now calculated at €148,000 (i.e., €140,000 + €8,000[329]). The same is true regarding the amount of double tax relief that is effectively provided with respect to the host state share of the tax pie. That amount also equals 20.3%.[330]

3.4.3.4 Intra-firm supplies of goods (capital asset transfers)

Outward bound notional capital asset transfers

Suppose that, all other things being equal to the 'Base Case', a capital asset, for instance an assembling machine is transferred from the home state branch A to the host state branch B for the purpose of durably employing it for the benefit of Johnson's business operations carried on through its branch B. Let us suppose that the capital asset was acquired 5 years ago and that its acquisition price was €600,000. Suppose that its economic lifetime equals 20 years, its residual value equals nil, and that the yearly tax deductible depreciation amount to €30,000. These are deducted from Johnson's worldwide operational profit of €200,000 resulting in a worldwide income of €170,000. Prior to the notional capital transfer, the asset was recorded on branch A's balance sheet for an amount of €450,000.[331] Suppose that at that time, its fair value, for whatever commercial reason, equals to €500,000 and that the remaining economic lifetime remains the same. Accordingly, taxpayer Johnson faces a latent corporate tax claim on the hidden reserve of €50,000.

Under the Dutch-style double tax relief methodology, Johnson's worldwide income does not alter upon the intra-firm capital transfer. The latent corporate tax claim on the hidden reserve does not become immediately due when transferring the capital asset abroad. Again, this is caused by the operation of the tax base reservation. And again, this is conceptually sound as taxpayer Johnson has not made a profit of €50,000 by just shipping the capital asset to its foreign branch abroad. Instead, the hidden reserve is added to the domestic taxable base year by year in an amount that varies directly proportional to the annual depreciation during the remaining economic lifetime of the transferred capital asset.[332]

Import neutrality promoting base exemption would prove distortive

Notably, would the home state have adopted an import neutrality promoting base exemption mechanism in this case, the intra-firm capital asset transfer would have led to a taxable event at this time – i.e., the levy of an 'exit tax' – resulting in corporate tax charge. This would have been conceptually unsound as Johnson has not actually derived income at that time. In fact no profit has been made upon the transfer of the assembling machine to a foreign country.[333] So why pay tax at that time?

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[325] 20,000 - 12,000 = 8,000.
[326] 12,000 - 5,000 = 7,000.
[327] (60,000 + 7,000) / (200,000 + 15,000) * 43,750 = 13,633.72.
[328] (8,000 / 15,000) * (43,750 / 215,000) * 15,000 = 1,627.91.
[329] 1,627.91 / 8,000 * 100% = 20.3%.
[330] 13,633.72 / (60,000 + 7,000) * 100% = 20.3%.
[331] 600,000 - 5 * 30,000 = 450,000.
[332] See on this matter Dutch Supreme Court, Hoge Raad, 12 February 1964, No. 15 068, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1964/95 (*Hopperzuiger*). See also Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010).
[333] In cases falling within the confines of the Treaty on Functioning of the European Union, the levying of such a tax conceptually infringes upon the freedom of establishment. See Court of Justice, cases C-9/02 (*De Lasteyrie du*

Back to the Dutch-style double tax relief method

Let us return to the application of the Dutch-style double tax relief method. Technically things work out as follows. Irrespective of the capital asset transfer, taxpayer Johnson's worldwide income continues to amount to €170,000. Accordingly, the home state tax on Johnson's worldwide income amounts to €5,000 + €10,000 + €17,500[334] = €32,500, which equals an average effective tax rate of 19.1%.[335] For the purpose of subsequently calculating the double tax relief, the intra-firm dealing, i.e., the notional capital asset transfer is recognized for double tax relief purposes. The latent corporate tax claim needs to be allocated to the home state as value has been added, i.e., income has accrued, in the home state – at least, from an origin based perspective that is.

In terms of the allocation of business income under origin based supply side allocation factors this makes sense. Viz., Johnson durably employs its capital asset, the assembling machine, for the purpose of its business in the home state to the time of the machine's transfer abroad. Following its transfer, the capital asset is further employed for Johnson's activities in the host state. Hence, this calls for a split of tax base between the home state and the host state. In terms of the allocation of profits on an origin basis, the unrealized capital gain of €50,000 should be allocated to the home state as the production factor capital, the machine, was employed in the home state during the period of capital accrual. Movements in the machine's value subsequent to its transfer to the host state should be allocated to the host state – that is, in terms of applying an origin based allocation factor.

In effect, due to a notional remuneration 'paid' in the host state to the home state of €500,000 in yearly instalments in return for the notional supply of goods from the home state to the host state, i.e., the capital asset transfer, this part of Johnson's worldwide tax base is transferred from the host state to the home state. The amount of the tax base transferred corresponds to €50,000 (500,000 – 450,000) i.e., the amount of notional 'capital gain' divided into yearly instalments. To ensure this, the asset is recorded on the host state branch B's balance sheets at its fair value of €500,000 rather than the lower book value for tax purposes of €450,000. Accordingly, for the purpose of calculating the double tax relief, the (tax deductible) yearly depreciation is taken into consideration against that fair value, i.e., €33,333.33,[336] instead of the book value for tax purposes, i.e., €30,000. The latter amount, notably, is the depreciation to be taken into consideration for the purpose of determining Johnson's worldwide income in the home state.

Consequently, under the double tax relief mechanism, the numerator in the fraction is calculated at €60,000 – €33,333.33, while the contribution of branch B to Johnson's worldwide income in the denominator of the fraction is calculated at €60,000 – €30,000. The increased amount of €3,333.33 (i.e., 33,333.33 - 30,000) equals to the difference between the capital asset's book value and its fair value as divided by the number of years corresponding to its remaining economic lifetime (i.e., €50,000 / 15 depreciation). The application of the fraction results in an amount of double tax relief of €5,098.04.[337] The tax payable in the home state accordingly amounts to €32,500 - €5,098.04 = €27,401.96. The home state tax due equals an average effective tax rate in the home state of 19.1% on the home state share of the tax pie, calculated at €143,333.33 (i.e., €140,000 + €3,333.33).[338] The same is true for the amount of double tax relief that is effectively granted with respect to the host state share of the tax pie. That amount also equals 19.1%.[339]

Saillant) and C-470/04 (*N.*). Contra, Court of Justice, cases C-250/95 (*Futura*), C-414/06 (*Lidl*) and C-337/08 (*X Holding*). See on the Court of Justices ambiguous approach in this respect Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010). See also Dennis M. Weber, 'Refusal of advantages of a cross-border tax consolidation in some situations an unjustified restriction of the freedom of establishment', *Highlights and Insights on European Taxation* 2010/1.6.

[334] 25% * 70,000 = 17,500.

[335] (32,500 / 170,000) * 100% = 19.1%.

[336] 500,000 / 15 year terms = 33,333.33.

[337] (60,000 – 33,333.33) / (200,000 – 30,000) * 32,500 = 5,098.04.

[338] 27,401.96 / 143,333.33 * 100% = 19.1%.

[339] 5,098.04 / (60,000 – 33,333.33) * 100% = 19.1%.

Hence, the double tax relief methodology results in an annual reduction of the amount of double tax relief for a period that corresponds to the remaining economic lifetime of the respective transferred capital asset. And this leads to *a pro rata parte* increase of the corporate tax annually payable in the home state during that same period. In this case, the hidden reserve is taxed in 15 annual instalments of €3,333.33. Were all things to remain equal during the remaining economic lifetime of the transferred capital asset, the increased amount of tax yearly due equals €637.25,[340] an amount that corresponds to an average effective tax rate of 19.1%.[341] On an overall basis, the tax payable on the hidden reserve of €50,000 in the home state amounts €9,558.82 (i.e., 15 terms * 637.25). This equals an average effective tax rate of 19.1% on the hidden reserve (i.e., 9,558.82 / 50,000) – inflation and mutations in the applicable tax rate not considered.

Notably, if the capital asset would have been disposed of against its fair value immediately following its transfer abroad, the corporate tax would become due in the home state on the capital gain of €50,000 realized at that time. No double tax relief would be available as the capital gain would not be attributed to the operations carried on through branch B. That is, the capital gain attributable to branch B would amount to nil, i.e., 500,000 – 500,000, as the capital asset is recorded on branch B's balance sheet at its fair value. Accordingly, the numerator in the fraction would amount to nil. Furthermore, if the capital asset is disposed for an amount of say €540,000 later that tax year, the capital gain attributable to branch B would amount to €40,000, i.e., 540,000 – 500,000. That amount would be included in the numerator in the fraction, having the effect that, to that extent, double tax relief is granted to our taxpayer Johnson. If the capital asset is sold at a loss, that capital loss would reduce Johnson's worldwide income, and in conjunction with that simultaneously reduce the amount of foreign income included in the numerator of the fraction.

Inward bound notional capital asset transfers

Now imagine the *reverse situation* and suppose that the capital asset is transferred from branch B to branch A. Again, Johnson's worldwide income does not alter upon the intra-firm capital transfer. It continues to amount to €170,000. Prior to the notional capital transfer, the asset was recorded on branch B's balance sheet at an amount of €450,000.[342] Accordingly, taxpayer Johnson has a latent double tax relief entitlement on the foreign source hidden reserve of €50,000.

Under the double tax relief methodology, Johnson's worldwide income does not alter upon the intra-firm capital transfer. The latent double tax relief entitlement on the hidden reserve does not, or at least should not, become available at the time of the transfer of the capital asset from abroad to the home state of Johnson. Viz., the capital asset transfer does not affect taxpayer Johnson's worldwide income. Again, this is caused by the operation of the tax base reservation. And again, this is conceptually sound as taxpayer Johnson has not in fact derived a capital gain of €50,000 by just shipping the capital asset from its branch abroad to its domestic branch with respect of which double tax relief should be made available. Instead, substantially the latent double tax relief entitlement becomes available in yearly terms which vary directly proportional to the annual depreciation during the remaining economic lifetime of the capital asset transferred. These terms increase the amount of foreign source income and, accordingly, the amounts of double tax relief provided. This reduces the corporate tax annually payable.

Import neutrality promoting base exemption would prove distortive

Notably, would the intra-firm capital asset transfer from branch B to branch A at this time be recognized as a taxable event in the host state and resulting in a corporate tax charge i.e., the levy of an 'exit tax' as is the case under an import neutrality promoting base exemption

[340] 3,333.33 / 170,000 * 32,500 = 637.25.
[341] 637.25 / 3,333.33 * 100% = 19.1%.
[342] 600,000 - 5 * 30,000 = 450,000.

system, this would be conceptually unsound as the taxpayer has not actually derived income at that time. No profit was in fact made.[343] So why pay tax?

Back to the Dutch-style double tax relief method

Let us return to the application of the Dutch-style double tax relief method. Technically things should work out as follows. Irrespective of the capital asset transfer, taxpayer Johnson's worldwide income continues to amount to €170,000, i.e., €200,000 - €30,000. Accordingly the home state tax on Johnson's worldwide income amounts to €32,500, which again equals an average effective tax rate of 19.1%.[344] For the purpose of subsequently calculating the double tax relief, the intra-firm dealing, i.e., the notional capital asset transfer is recognized for double tax relief purposes. The latent corporate tax claim on the hidden reserve needs to be allocated to the host state as value has been added, i.e., income has accrued in the host state – at least, from an origin based perspective that is.

In terms of the allocation of business income under origin based supply side allocation factors this makes sense. Viz., Johnson durably employs its capital asset, the assembling machine, for the purpose of its business in the host state to the time of the machine's transfer to the home state. Following its transfer, the capital asset is further employed for Johnson's activities in the home state. Hence, this calls for a split of the tax base between the host state and the home state. In terms of the allocation of profits on an origin basis, the unrealized capital gain of €50,000 should be allocated to the host state as the production factor capital, the machine, was employed in the host state during the period of capital accrual, i.e., Belgium in the current example. Movements in the machine's value subsequent to its transfer to the home state should be allocated to the home state, i.e., the Netherlands in the current example. That is, again in terms of applying an origin based allocation factor. Due to a notional remuneration of €500,000 'paid' in the home state – i.e., in yearly instalments – to the host state in return for the notional supply of goods from the host state to the home state, i.e., the capital asset transfer, part of Johnson's worldwide tax base is transferred from the home state to the host state corresponding to a notional 'capital gain', i.e., in yearly instalments of €50,000 (500,000 – 450,000).

Under the double tax relief mechanism the numerator is calculated at €60,000 + €3,333.33.[345] The latter amount equals the *pro rata parte* capital gain recognized upon the notional capital asset transfer at the level of branch B for double tax relief purposes. That amount equals the difference between the capital asset's book value for tax purposes and its fair value as divided by the number of years corresponding to its remaining economic lifetime (i.e., €50,000 / 15 times the annual depreciation). Consequently, the application of the fraction results in an amount of double tax relief of €12,107.84.[346] The tax payable in the home state accordingly amounts to €32,500 - €12,107.84 = €20,392.16. The home state tax due equals an average effective tax rate in the home state of 19.1% on the home state share of the tax pie, calculated at €106,666.67.[347]

Notably, that latter amount, i.e., the home state share of the tax pie, can be understood as follows. Upon its transfer from the branch located abroad, the capital asset should be recorded on branch A's balance sheets at its fair value of €500,000 rather than its book value of €450,000. Viz., the hidden reserve has a foreign source. That amount of €500,000

[343] In cases falling within the confines of the Treaty on Functioning of the European Union, the levying of such an exit tax conceptually infringes upon the freedom of establishment. See Court of Justice, cases C-9/02 (*De Lasteyrie du Saillant*) and C-470/04 (*N.*). See also Court of Justice case C-527/06 (*Renneberg*). Contra, Court of Justice, cases C-250/95 (*Futura*), C-414/06 (*Lidl*) and C-337/08 (*X Holding*). See on the Court of Justices ambiguous approach in this Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010). See also Dennis M. Weber, 'Refusal of advantages of a cross-border tax consolidation in some situations an unjustified restriction of the freedom of establishment', *Highlights and Insights on European Taxation* 2010/1.6.

[344] (32,500 / 170,000) * 100% = 19.1%.

[345] 33,333.33 - 30,000 = €3,333.33. The increased amount of €3,333.33 again equals the difference between the capital asset's tax bookkeeping value and its fair value as divided by the number of years corresponding with its remaining economic lifetime.

[346] (60,000 + 3,333.33) / (200,000 – 30,000) * 32,500 = 12,107.84.

[347] 20,392.16 / 106,666.67 * 100% = 19.1%.

subsequently constitutes the basis on which the annual deprecation, i.e., €33,333.33,[348] is calculated. Accordingly, the contribution of branch A to taxpayer Johnson's worldwide income upon the notional capital asset transfer amounts to €140,000 - €33,333.33 = €106,666.67. The amount of double tax relief granted with respect to the host state share of the tax pie effectively equals 19.1% as well.[349]

Hence, the double tax relief methodology results in an annual increase of the amount of double tax relief provided in the home state for a period that corresponds to the remaining economic lifetime of the capital asset transferred. And this leads to a *pro rata parte* reduction of the corporate tax annually payable in the home state during that same period. In this case, the double tax relief entitlement regarding the foreign source hidden reserve is granted in 15 annual instalments of €3,333.33. Were all things to remain the same during the remaining economic lifetime of the transferred capital asset, the reduction of corporate tax yearly due equals €637.25,[350] an amount corresponding to an average effective tax rate reduction of 19.1%.[351] On an overall basis, the reduction of tax payable in the home state would amount to €9,558.82 (i.e., 15 * 637.25). This equals an effective tax reduction of 19.1% on the hidden reserve (i.e., 9,558.82 / 50,000) – inflation not considered.

Notably, would the capital asset have been disposed of at its fair value immediately following its transfer abroad, double tax relief would be granted on the capital gain of €50,000 realized at that time. Double tax relief would be available as the capital gain would be attributed to the operations carried on through branch B. The numerator of the fraction would increase by €50,000. Notably, the capital gain attributable to branch A would amount to nil (i.e., 500,000 – 500,000) as the capital asset is recorded on branch A's balance sheets at fair value. Furthermore, would the capital asset have been disposed of later that tax year at an amount of, again say €540,000, the capital gain attributable to branch A would amount to €40,000 (i.e., 540,000 – 500,000). That amount would not be included in the numerator in the fraction resulting in no double tax relief for our taxpayer Johnson to that extent. The capital gain attributable to branch B would still amount to €50,000. And only to that extent, double tax relief would be provided.

3.4.4 Currency exchange results

3.4.4.1 Allocation of currency exchange pro rata parte

The Dutch-style double tax relief mechanism entails an allocation of tax across tax jurisdictions proportional to income derived in cases where currency exchange results are realized. In this respect, three scenarios may occur:

1. Currency exchange results arise at home, scenario (i);
2. Currency exchange results arise abroad, scenario (ii), and;
3. Currency exchange results arise both at home and abroad, scenario (iii);

Ad scenario (i)

Currency exchange results that arise in the home state are not included in the double tax relief mechanism.[352] Such currency exchange results remain part of the home state part of the

[348] 500,000 / 15 year terms = 33,333.33.
[349] 12,107.84 / (60,000 + 3,333.33) * 100% = 19.1%.
[350] 3,333.33 / 170,000 * 32,500 = 637.25.
[351] 637.25 / 3,333.33 * 100% = 19.1%.
[352] See Dutch Supreme Court, Hoge Raad, 4 May 1960, No. 14 218, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1960/163 and Dutch Supreme Court, Hoge Raad, 29 April 1959, No. 13 892, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1960/164 (*Rupiah*) confirmed by Dutch Supreme Court, Hoge Raad, 10 March 1993, No. 28 017, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1993/209, as well as Dutch Supreme Court, Hoge Raad, 5 December 2003, No. 37 743, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 2004/139 (*Cruzeiro*). Furthermore, see Dutch Supreme Court, Hoge Raad, 31 March 1954, No. 11 518, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1954/180. See for some analysis Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international (*2011), at section 2.7. Notably, the Dutch tax legislator has adopted functional currency tax reporting rules for administrative convenience reasons

tax base and influence the home state tax burden imposed on home state source income accordingly. Positive currency exchange results are taxed, negative currency exchange results are tax deductible.[353] Save for the hedging of currency exchange risks, currency exchange results arise in the home state in cases where resident taxpayers keep their tax books with respect to their foreign operations in the host state currency – i.e., where they have locally situated assets and liabilities in local currencies whereas their worldwide income is calculated in the home state currency, i.e., the Euro in the current example. Accordingly, tax deductible/taxable currency exchange results are recognized for home state corporate tax purposes where the taxpayer carries on economic activities in tax jurisdictions employing currencies other than the Euro.

Subsequently, no double tax relief is provided regarding such home state source currency exchange results. This is conceptually sound. These results do not arise abroad as host state tax reporting occurs in local currencies – just as the home state (i.e., Dutch) tax reporting occurs in Euro. Accordingly, currency exchange results realized due to differences in values between the Euro and the respective host state currencies do not arise in those host state tax jurisdictions as these income items, by their nature, are not recognized in those jurisdictions for local tax calculation purposes. Accordingly, there is no need to take such currency exchange result into account for double tax relief purposes in the home state.

Double tax relief is only granted with respect to income that arises in the host state and is taxed abroad. This scenario is further explored by means of numerical examples in sections 3.4.4.2 – effects under current Dutch international tax law – and 3.5.3.4 – effects under advocated approach – hereunder. Notably, in practice, this may be referred to as the typical scenario. Under European Union law, a similar case was at hand in *Deutsche Shell*, in which the Court of Justice, notably thereby ruling the German tax rules applied incompatible with the European Union fundamental freedoms, adopted the same approach as set out in the above set of paragraphs.

Ad scenario (ii)

In the second, opposite, scenario, i.e., in cases where currency exchange results do arise in the host state, these results are included in the double tax relief mechanism in the home state and do not influence the home state tax burden imposed on home state source income accordingly. Such currency exchange results in effect are considered part of the foreign tax base.

Save where currency exchange risks are hedged, currency exchange results arise in the host state in cases where resident taxpayers keep their tax books with respect to their foreign operations in the home state currency, the Euro in the current example, i.e., where they have locally situated assets and liabilities in Euro, whereas their worldwide income is calculated in Euro. Accordingly, tax deductible/taxable currency exchange results are recognized in the host state if such taxpayers carry on economic activities in host state tax jurisdictions that employ currencies other than the Euro. Such currency exchange results are deemed not to have arisen in the home state, as home state tax reporting occurs in Euro. Therefore such currency exchange results are not taken into account for home state corporate tax purposes.

Subsequently, double tax relief is provided regarding such host state source currency exchange results realized. This is conceptually sound. These results arise abroad since the

(Article 7, fifth indent, Dutch CITA). These are not further discussed. The Court of Justice takes a similar stand in case C-293/06 (*Deutsche Shell*).

[353] An alternative to recognize currency exchange results for corporate tax purposes would be to exempt them from the taxable corporate base. Such an approach would not be conceptually sound. Currency exchange risks are actual commercial risks. These risks – in the event that they have not been hedged – may lead to actual mutations in the taxpayer's equity capital. In my view, this economic reality should be acknowledged for corporate tax purposes, irrespective of the technical difficulties that may emerge from this when calculating the corporate tax liability. Hedge accounting could be applied for corporate tax purposes in scenarios where the currency exchange risks have been hedged. The aforementioned issues involving the corporate tax implications of currency exchange results would then not arise. That is, as currency risks do not commercially materialize to the extent that the risks involved are effectively hedged.

foreign tax burden is calculated in host state currencies. Consequently, currency exchange results realized due to differences in values between the Euro and the respective host state currencies arise in these host state tax jurisdictions. Accordingly, such currency exchange results are taken into account for home state double tax relief purposes. This scenario is further explored by means of numerical examples in sections 3.4.4.3 and 3.5.3.4.

Ad scenario (iii)

In the third scenario, i.e., the scenario in which currency exchange results arise in both the home state and the host state, these results are partially included in the double tax relief mechanism and partially influence the home state tax burden imposed on home state source income accordingly. Save where currency exchange risks are hedged, this occurs in cases in which home state resident taxpayers keep their tax books with respect to their foreign operations in the currency of a third country. That is, where they have locally situated assets and liabilities in the currency of a third country, i.e., a currency other than the local currency or the Euro, while their worldwide income is being calculated in the home state currency, i.e., the Euro in the current example.

Under the application of the Dutch-style tax exemption mechanism, the effects are as follows in such a scenario. Tax deductible/taxable currency exchange results arise locally when home state resident taxpayers carry on economic activities in foreign jurisdictions that have a currency other than the Euro. Local currency exchange results in event of fluctuations between the currency of the third country and the local currency. In addition, tax deductible/taxable currency exchange results arise in the home state as well. Home state source currency exchange results when the value currency of the third country fluctuates against the Euro.

Subsequently, double tax relief is provided regarding the currency exchange results 'third country currency / the local currency'. This makes sense. Such currency exchange results arise abroad. These foreign source income items are taken into account for double tax relief purposes. On the contrary, no double tax relief is provided regarding the currency exchange results 'third country currency / Euro'. This makes sense also. Such currency exchange results arise in the home state. Home state source income items are not taken into account for double tax relief purposes. Hence, at the end of the day, in terms of tax burdens imposed regarding home state source income, the home state acknowledges the currency exchange results 'third country currency / Euro'. And the host state in which the home state resident taxpayer carries on its business operations recognizes the local/third country currency exchange result for which the home state provides double tax relief by means of the Dutch-style tax exemption method. This scenario is further explored by means of numerical examples in sections 3.4.4.4 and 3.5.3.4.

These effects can be best explained again through numerical examples. Let us therefore return to our taxpayer Johnson and elaborate a bit further.

3.4.4.2 Scenario (i) – US Branch B's tax books are kept in US Dollar

Let us introduce a currency exchange issue into our 'Base Case'. Suppose that, contrary to the 'Base Case' as referred to in section 3.4.1., State X now is the United States of America (instead of in Belgium). Viz., currency exchange issues in the relationship between the Netherlands and Belgium do not arise as both states are part of the European Monetary Union. Both apply the Euro as their currency. Hence, it is necessary to analytically 'relocate' Johnson's branch B to a state that applies a currency than the Euro, for instance the United States. The United States of America adopts the US Dollar ($) as its currency for US corporate tax calculation purposes. Johnson's worldwide income is calculated in Euro for Dutch corporate tax purposes. Suppose that, contrary to the default scenario, Johnson's tax books of branch B are kept in the US Dollar and the books of branch A are kept in the Euro. Accordingly, branch B's assets, liabilities and equity, as well as its expenses and receipts are booked in US Dollars. Branch A's equivalents are kept in Euro.

Case a); US Dollar increases in value

In addition, let us suppose that $1 is worth €1 at the start of the tax year. And suppose that the exchange rate of the US Dollar increases in value during the tax year: at the end of this period $1 is worth €1.25. Obviously, the Euro rate concurrently decreases during this period. At the end of the tax year, €1 is worth $0.80.[354] Notably, it is taken as an presupposition that the global currency exchange rate markets clear.[355]

Under the Dutch-style double tax relief methodology, Johnson's worldwide income increases as the value of US Dollars increases. The currency exchange result is not recognized for double tax relief purposes as the income arises in the home state. Before proceeding to the technical overview, the following side note should be made (see fig. 9).

Fig. 9. Some assumptions for simplicity reasons

1. Currency exchange rate effects are calculated by reference to changes in equity during tax accounting period

For the sake of simplicity, the currency exchange effects are calculated by reference to the currency exchange rate fluctuation on the branch's equity movement. In Dutch tax practice, the currency exchange results are calculated by reference to the value of the taxpayer's individual assets and liabilities. Furthermore, under the Dutch approach adopted for the purpose of allocating business proceeds to tax years, the so-called principle of sound business practice ('*goed koopmansgebruik*'), a further distinction is made between the taxpayer's individual long-term and short-term tangible and intangible assets and liabilities. Subsequently, a distinction is made, where appropriate, between the currency exchange results realized on profits and on capital gains, to be calculated, by reference to historical rates or the average monthly rates or daily rates depending on facts and circumstances. This makes things technically somewhat more complex in practice. Conceptually, however, things are not materially different for double tax relief calculation purposes. Hence, it is assumed that all in currency exchange rates fluctuation result in a realization of a taxable profit or tax-deductible loss for Dutch income tax purposes.

Moreover, it is assumed that the currency exchange result may be calculated by reference to the fluctuation in the respective currency's value during the accounting period. This enables a relatively straightforward determination of the currency exchange result in the examples by multiplying the change in the currency exchange rate with Johnson's overall equity movement.

Furthermore, the currency exchange rate effect on Johnson's equity capital issued (nominal equity capital and equity premium) is ignored. Only the effects of currency exchange rate fluctuations on the changes to in Johnson's equity capital are taken into consideration. Accordingly, the currency effect on the issued equity capital is deemed to be realized for tax purposes when the business is no longer operated and the company is liquidated or wound up. This is assumed both for the sake of simplicity and to avoid that the currency exchange effects would otherwise overshadow Johnson's operational business proceeds.

2. Currency exchange rate effects are calculated by reference to spot rate on the first day of the accounting period

And finally, for reasons of simplicity, the currency exchange result on the business profits realized is calculated by reference to the spot rate at the opening of the accounting period, i.e., on 1/1. In Dutch tax practice the currency exchange results are calculated by reference to the average currency exchange rate in the accounting period – i.e., the approach in Dutch tax practice considers business profit realized at the average spot rate (rather than the 1/1 spot rate as used in the following numerical exercises).

This being said, technically, things work out as follows. Johnson's worldwide income amounts to €215,000 (i.e., 200,000 + 15,000). The latter amount, i.e., the profit of €15,000 is equal to

[354] 1 / 1.25 = 0.80.

[355] Short-term imbalances occur in practice. These may be commercially exploited. This may be illustrated by pointing at the possibilities in practice to derive income from currency carry trading, i.e. the (short-term) borrowing of money in a low-interest rate currency (typically of a stronger economy) for the purpose of using the funds to invest in an asset (e.g. a long-term bond) in a different currency with a higher interest rate (i.e. typically of a weaker economy). This may enable a currency carry trader to make money by capturing the difference between the rates. Substantial profits (or losses) may be derived through carry trade when leverage is taken into consideration.

the increase in value recognized upon the conversion of branch B's profit of $60,000 into Euro (i.e., 60,000 * 1.25 – 60,000 * 1). The home state tax on Johnson's worldwide income amounts to €5,000 + €10,000 + €28,750[356] = €43,750 which equals an average effective tax rate of 20.3%.[357]

For the purpose of subsequently calculating the double tax relief, the currency exchange result is not recognized for double tax relief purposes as there is no currency exchange result in the host state, the United States in the current example. Consequently, under the double tax relief mechanism the numerator in the fraction is calculated at €60,000. The fraction subsequently applied under the double tax relief mechanism equals to €12,209.30.[358] The tax payable in the home state accordingly amounts to €43,750 – €12,209.30 = €31,540.70. The home state tax due equals an average effective tax rate in the home state of 20.3% on the home state share of the tax pie calculated at €155,000 (i.e., €140,000 + €15,000).[359] The same is true regarding the amount of double tax relief that is effectively granted with respect to the host state's share of the tax pie, i.e., the United States in the current example. That amount equals 20.3% as well.[360]

Import neutrality promoting base exemption would prove distortive

If the home state would have adopted an import neutrality promoting base exemption system, the currency exchange result realized for tax purposes on Johnson's income derived through its host state branch B in US Dollars would not be taken into account for home state tax purposes. In such a case Johnson's branch B income, including the currency exchange result Euro/ US Dollar would have been exempt from the tax base. Only the home state source income, i.e., branch A's income derived of €140,000 would have been taxable in the home state. Consequently, the payable home state tax would have amounted to €5,000[361] + €10,000[362] + €10,000[363] = €25,000.

Please note that the home state tax burden imposed in such a case is not 17.9%.[364] As Johnson actually realizes a currency exchange result on its US branch B's income, this should be taken into account for tax burden calculation purposes. The application of an import neutrality promoting base exemption rather than the Dutch-style tax exemption method does not mean that currency exchange results all of a sudden would not arise in the home state any more. The only thing changed is the application of a different double tax relief method. The tax payable in the home state under a base exemption method of €25,000 would substantially mean the levy of an effective tax imposed at a rate of 16.1%,[365] rather than the above mentioned 20.3%.

What does this mean? This means that an import neutrality promoting base exemption mechanism arbitrarily affects the tax burden imposed, as it disregards economically substantive income items for tax calculation purposes. Despite the fact that macro-economic currency exchange effects cannot be influenced on a micro-economic level, i.e., at the level of individual taxpayers, currency exchange results actually impose commercial risks and currency exchange results actually affect income levels.

Taxpayer Johnson would have been better off in the example. The tax burden imposed equals 16.1% instead of 20.3%. However, this is just by chance. The relaxed burden is the consequence of the fact that the US Dollar increased in value, whilst the increase is not taken into account for tax calculation purposes. Moreover, the application of the base exemption

[356] 25% * 115,000 = 28,750.
[357] (43,750 / 215,000) * 100% = 20.3%.
[358] 60,000 / (200,000 + 15,000) * 43,750 = 12,209.30.
[359] 31,540.70 / 155,000 * 100% = 20.3%
[360] 12,209.30 / 60,000 * 100% = 20.3%. Notably, the sum of 12,209.30 and 31,540.70 equals 43,750.
[361] 10% * 50,000 = 5,000.
[362] 20% * 50,000 = 10,000.
[363] 25% * 40,000 = 10,000.
[364] 25.000 / 140.000 * 100% = 17.9%.
[365] 25,000 / (140,000 + 15,000) * 100% = 16.1%.

mechanism moderates the internationally commonplace progressiveness effects in the employed tax rate structures. Johnson would have benefited from the income split effect.

But tomorrow, reality may be different. The US Dollar may decrease in value. Johnson may have suffered a loss from its foreign operations. That would cancel out the advantages. The dices would have rolled against Johnson. At the end of the day by exempting currency exchange results from the tax base the market is distorted. Currency exchange results cannot be influenced individually. The question of whether the tax burden imposed ends up in a more relaxed or heavier burden is a game of chance.

This clearly distorts the decision of whether or not to do business across a tax border as one cannot oversee the outcome hereof in terms of tax burdens imposed beforehand. Internal equity and capital and labor neutrality call for equal tax treatment in equal cases.

Court of Justice agrees; *Deutsche Shell*

Worth mentioning is that the Court of Justice has ruled in line with the aforementioned reasoning in the *Deutsche Shell* case[366] which ruling is applicable in cases falling within the confines of the Treaty on Functioning of the European Union, The *Deutsche Shell* case dealt with the compatibility or incompatibility with the European Union fundamental freedoms of the German tax treatment of currency exchange losses suffered in the course of business operations carried on abroad. Until the Court of Justice's ruling Germany exempted resident taxpayer's currency exchange losses realized on their foreign business operations from the German tax base. The Deutsche Shell case involved a German resident taxpayer that operated a business in Italy. The German taxpayer's Italian activities were reported in Liras for tax purposes (this was prior to the introduction of the Euro). As the German Mark increased in value vis-à-vis the Italian Lira the German taxpayer suffered a currency loss. This loss was not tax-deductible in Germany as Germany exempted such losses from the tax base.

As a consequence of the application of such a base exemption, the German international tax system made it less attractive for German resident taxpayers to get involved in intra-European Union cross-border economic activities. Viz., these taxpayers did not have any upfront knowledge as to the German tax burden imposed in respect of their income realized at the end of the day. Currency exchange rates cannot be influenced individually yet impose real economic risks. By not taking into account actual currency exchange losses for German income tax purposes, i.e., by means of exempting these income items from the tax base, the Court of Justice considered the German tax rules to infringe upon the 'market access principle' and accordingly found these rules to be a restriction that was incompatible with the European Union fundamental freedoms. Now let us return to the effects of the Dutch-style double tax relief method.

Case b); US *Dollar drops in value*

Let us imagine the *reverse situation* in which the US Dollar drops in value during the tax year. At the end of this period $1 is worth €0.80. The Euro rate concurrently increases: at the end of the tax year, €1 is worth $1.25.

Under the double tax relief methodology, Johnson's worldwide income decreases as the value of the US Dollar decreases. The currency exchange result is not recognized for double tax relief purposes. Technically, things work out as follows. Taxpayer Johnson's worldwide income amounts to €188,000 (i.e., 200,000 – 12,000). The latter amount, i.e., the loss of €12,000 is equal to the decrease in value recognized upon the conversion of branch B's profit of $60,000 into Euro (i.e., 60,000 * 0.80 – 60,000 * 1). The home state tax on Johnson's worldwide income amounts to €5,000 + €10,000 + €22,000[367] = €37,000, which equals an average effective tax rate of 19.7%.[368] For the purpose of subsequently calculating the double

[366] Court of Justice, case C-293/06 (*Deutsche Shell*).
[367] 25% * 88,000 = 22,000.
[368] (37,000 / 188,000) * 100% = 19.7%.

tax relief, the currency exchange result is not recognized for double tax relief purposes as there is no currency exchange result in the host state, the United States. Consequently, under the double tax relief mechanism, the numerator in the fraction is calculated at €60,000. The fraction subsequently applied under the double tax relief mechanism equals to €11,808.51.[369] The tax payable in the home state accordingly amounts to €37,000 – €11,808.51 = €25,191.49. The home state tax due equals an average effective tax rate in the home state of 19.7% on the home state share of the tax pie, calculated at €128,000 (i.e., €140,000 – €12,000).[370] The same is true regarding the amount of double tax relief that is effectively granted with respect to the host state's share of the tax pie. It also equals 19.7%.[371]

Import neutrality promoting base exemption would prove distortive

If the home state would have adopted an import neutrality promoting base exemption system, the currency exchange result realized for tax purposes on Johnson's income derived through its US branch B in US Dollars would not be taken into account for home state tax purposes. Again the income of Johnson's branch B, including the currency exchange result Euro/US Dollar would have been exempt from the tax base. Only the income derived from the activities carried on through branch A of €140,000 would have been taxable in the home state. As said, the tax payable in the home state would have amounted to €25,000. That would substantially entail the levy of an effective tax at a rate of 19.5%[372] instead of the above-mentioned 19.7%.

Johnson would have been lucky. The dices would have rolled in Johnson's favor. He would be better off in terms of tax burdens imposed. The disadvantage imposed as a consequence of the non-recognition of the currency exchange loss on the US Dollar would have been compensated by the benefits derived from the progressiveness moderating income split alongside Dutch and US tax borders. Back to the Dutch-style tax exemption.

3.4.4.3 Scenario (ii) – US Branch B's tax books are kept in Euro

Now suppose that, contrary to the two cases referred to in the above section 3.4.4.2, both the books of branch B and branch A are kept in Euro for tax purposes. Accordingly, both branch A's and branch B's assets, liabilities and equity, as well as its expenses and receipts are recorded in Euro.

Case c); US Dollar increases in value

Furthermore suppose that the US Dollar conversion rate again increases from €1 to €1.25 during the tax year.

Under the double tax relief methodology, Johnson's worldwide income does not alter. It continues to be €200,000. This is conceptually sound as taxpayer Johnson keeps its books in Euro for home state corporate tax purposes and, accordingly, no currency exchange result arises in the home state. The home state tax on Johnson's worldwide income accordingly amounts to €5,000 + €10,000 + €25,000[373] = €40,000, an average effective tax rate in the home state of 20%. Subsequently, the double tax relief is calculated. The amount of relief alters in comparison with the default scenario since a currency loss of $12,000 (60,000 * 0.80 – 60,000 * 1) arises in the host state. The amount of $12,000 equals the decrease in value recognized upon the conversion of the branch B's profit of €60,000 into $48,000. This effect is recognized for double tax relief purposes. The application of the fraction entails double tax relief amounting to €9,600.[374] The tax payable in the home state accordingly amounts to €40,000 – €9,600 = €30,400, an average effective tax rate in the home state of 20% on the home state share of the tax pie, calculated at €152,000 (i.e., €140,000 + €12,000). The same

[369] 60,000 / 200,000 – 12,000) * 37,000 = 11,808.51.
[370] 25,191.49 / 128,000 * 100% = 19.7%
[371] 11,808.51 / 60,000 * 100% = 19.7%. Notably, the sum of 11,808.51 and 25,191.49 equals 37,000.
[372] 25,000 / (140,000 – 12,000) * 100% = 19.5%.
[373] 25% * 100,000 = 25,000.
[374] (60,000 – 12,000) / 200,000 * 40,000 = 9,600.

is true regarding the double tax relief that is effectively granted with respect to the host state's share of the tax pie; that equals 20% as well.[375]

Import neutrality promoting base exemption is distortive

If the home state were to have adopted an import neutrality base exemption system, the payable home state tax would again have amounted to €25,000. That would substantially entail the levy of an effective tax at a rate of 16.4%[376] instead of the above mentioned 20%.

Again, Johnson would have been lucky. The US Dollar increased, whilst this fact arbitrarily would not have been taken into account for home state tax calculation purposes indeed. Moreover, Johnson would have benefited from the income split. Back to the Dutch-style tax exemption method.

Case d); US Dollar drops in value

Now imagine the *reverse situation* in which the US Dollar drops in value during the tax year. Again, $1 is worth €0.80 at the end of this period. And the Euro rate concurrently increases from €1 to $1.25.

Under the double tax relief methodology again Johnson's worldwide income does not alter. It still amount to €200,000. And again this is conceptually sound as taxpayer Johnson keeps its books in Euro for home state corporate tax purposes and accordingly there is no currency exchange result in the home state. The home state tax on Johnson's worldwide income accordingly amounts to €40,000. Again, the amount of relief alters in comparison with the default scenario as a currency gain of $15,000 is realized in the host state. The amount of $15,000 is equal to the increase in value recognized upon the conversion of branch B's profit of €60,000 into $75,000 (i.e., 60,000 * 1.25 – 60,000 * 1). As this effect is recognized for double tax relief purposes, the application of the fraction entails double tax relief amounting to €15,000.[377] The tax payable in the home state accordingly amounts to €40,000 – €15,000 = €25,000, an average effective tax rate in the home state of 20% on the home state share of the tax pie, calculated at €125,000 (i.e., €140,000 – €15,000). The same is true regarding the double tax relief that is effectively granted with respect to the host state's share of the tax pie; that equals 20% also.[378]

Import neutrality promoting base exemption is distortive

If the home state would have adopted an import neutrality promoting base exemption system, the tax payable in the home state tax would again have amounted to €25,000. That would substantially entail the levy of an effective tax at a rate of 20%.[379] The tax burden would be equal to the tax burden as imposed under the Dutch-style tax exemption method as referred to in the above paragraph; a tie. The US Dollar decreased in value whilst this fact would not have been taken into account for home state tax calculation purposes. A split of Johnson's income between the home state and host state alongside the tax border would have barely compensated for this. Chances are. Now back to the Dutch-style tax exemption.

3.4.4.4 Scenario (iii) – US Branch B's tax books are kept in Japanese Yen

Now let us suppose that contrary to the four cases referred to in the above two sections the books of branch B are kept in Japanese Yen for tax purposes and that the books of branch A are kept in Euro. Accordingly, branch B's assets, liabilities and equity, as well as its expenses and receipts are recorded in Yen. Branch A's equivalents in Euro.

Case e); US Dollar increases in value

[375] 9,600 / 48,000 * 100% = 20%. Notably, the sum of 9,600 and 30,400 equals 40,000.
[376] 25,000 / (140,000 + 12,000) * 100% = 16.4%.
[377] (60,000 + 15,000) / 200,000 * 40,000 = 15,000.
[378] 15,000 / 75,000 * 100% = 20%. Notably, the sum of 15,000 and 25,000 equals 40,000.
[379] 25.000,00 / (140.000 – 15.000) * 100% = 20%.

Furthermore, let us suppose that $1 is worth €1 and ¥1 at the start of the tax year. And suppose that the exchange rate of the US Dollar increases during the tax year in respect of both the Euro and the Yen: at the end of this period $1 is worth €1.25 and ¥1.50. The Euro and Yen exchange rates concurrently decrease during this period. Accordingly, at the end of the tax year, ¥1 is worth €0.83[380] and $0.67.[381] €1 is worth $0.80.[382] And €1 is worth ¥1.20.[383] In a table (fig. 10):

Fig. 10. Exchange rates at the end of the accounting period

Exchange rates ($: €: ¥)			
	$	€	¥
$1	1	1.25	1.50
€1	0.80	1	1.20
¥1	0.67	0.83	1

Under the double tax relief methodology, Johnson's worldwide income alters as a tax deductible currency exchange result is recognized for home state corporate tax purposes with respect to fluctuation in value between the Yen and the Euro. Taxpayer Johnson's worldwide income amounts to €190,000 (i.e., 200,000 – €10,000). The latter amount, i.e., the loss of €10,000 equals to the decrease in value recognized upon the conversion of branch B's profit of ¥60,000 into Euro (i.e., 60,000 * 0.83 – 60,000 * 1). The home state tax on Johnson's worldwide income amounts to €5,000 + €10,000 + €22,500[384] = €37,500 which equals an average effective tax rate of 19.7%.[385] No double tax relief is granted with respect to this currency exchange result. This makes sense as this currency exchange result arises in the home state.

Subsequently, the double tax relief is calculated. For double tax relief purposes a currency exchange result is recognized with respect to fluctuation in value between the Yen and the US Dollar. This is conceptually sound as a currency loss of $20,000 (60,000 * 0.67 – 60,000 * 1) arises in the host state. The amount of $20,000 equals the decrease in value recognized upon the conversion of branch B's profit of ¥60,000 into $40,000. The application of the fraction entails double tax relief amounting to €7,894.74.[386] The tax payable in the home state accordingly amounts to €37,500 – €7,894.74 = €29,605.26, an average effective tax rate in the home state of 19.7% on the home state share of the tax pie, calculated at €150,000 (i.e., €140,000 + €10,000). The latter amount, i.e., the increase of €10,000 equals the difference in the value fluctuations between the Yen and the Euro on the one hand and the Yen and the US Dollar on the other (i.e., 60,000 * 0.83 – 60,000 * 0.67). In addition, the amount of double tax relief granted with respect to the host state share of the tax pie equals an effective relief of 19.7% as well.[387] Accordingly, the home state recognizes a tax deductible Euro/Yen currency exchange result of €10,000 for tax purposes when branch B's profits of ¥60,000 are converted into €50,000 (i.e., 60,000 * 0.83). In addition, the host state effectively recognizes a tax deductible US Dollar/Yen currency exchange result of $20,000 when branch B's profits of ¥60,000 are converted into $40,000 (i.e., 60,000.00 * 0.67).

Import neutrality promoting base exemption is distortive

Notably, were the home state to have adopted an import neutrality promoting base exemption system, the tax payable in the home state tax would again have amounted to €25,000. That would substantially entail the levy of an effective tax at a rate of 16.7%,[388] instead of the above mentioned 19.7%.

[380] 1.25 / 1.50 = 0.83.
[381] 1 / 1.50 = 0.67.
[382] 1 / 1.25 = 0.80.
[383] 1 / (1.25 / 1.50) = 1.20.
[384] 25% * 90,000 = 22,500.
[385] (37,500 / 190,000) * 100% = 19.7%.
[386] (60,000 – 20,000) / (200,000 – 10,000) * 37,500 = 7,894.74.
[387] 7,894.74 / 40,000 * 100% = 19.7%. Notably, the sum of 7,894.74 and 29,605.26 equals 37,500.
[388] 25,000 / (140,000 + 10,000) * 100% = 16.7%.

Johnson would have been lucky. The US Dollar increased in value, whilst this fact, indeed on an arbitrary basis again, would not have been taken into account for home state tax calculation purposes. Moreover, Johnson would have benefited from the income split alongside home state and host state tax borders. Let us return to the Dutch-style double tax relief method.

Case f); US Dollar drops in value

Now imagine the *reverse situation*. The US Dollar drops in value during the tax year in respect of both the Euro and the Yen. At the end of this period $1 is worth €0.80[389] and ¥0.67.[390] The Euro and Yen exchange rates concurrently increase in value during this period. Accordingly, at the end of the tax year, the Euro rate increases in value to $1.25.[391] The Yen rate concurrently increases in value, i.e., to $1.50[392] and €1.20.[393] At that time, €1 is worth ¥0.83.[394] In a table (fig. 11):

Fig. 11. Exchange rates

Exchange rates ($: €: ¥)			
	$	€	¥
$1	1	0.80	0.67
€1	1.25	1	0.83
¥1	1.50	1.20	1

Under the double tax relief methodology, Johnson's worldwide income again alters as a taxable currency exchange result is recognized for home state corporate tax purposes with respect to fluctuation in value between the Yen and the Euro. Taxpayer Johnson's worldwide income amounts to €212,000 (i.e., 200,000 + 12,000). The latter amount, i.e., the profit of €12,000 equals the increase in value recognized upon the conversion of branch B's profit of ¥60,000 into Euro (i.e., 60,000 * 1.20 – 60,000 * 1). The home state tax on Johnson's worldwide income amounts to €5,000 + €10,000 + €28,000[395] = €43,000 which equals an average effective tax rate of 20.3%.[396] Again no double tax relief is granted with respect to this currency exchange result. And again this makes sense as this currency exchange result arises in the home state.

Subsequently, the double tax relief is calculated. For double tax relief purposes a currency exchange result is recognized with respect to fluctuation in value between the Yen and the US Dollar. This is conceptually sound as a currency exchange result of $30,000 (60,000 * 1.50 – 60,000 * 1) arises in the host state. The amount of $30,000 is equal to the increase in value recognized upon the conversion of branch B's profit of ¥60,000 into $90,000. The application of the fraction entails double tax relief amounting to €18,254.72.[397] The tax payable in the home state accordingly amounts to €43,000 – €18,254.72 = €24,745.28, an average effective tax rate in the home state of 20.3% on the home state share of the tax pie, calculated at €122,000 (i.e., €140,000 – €18,000). The latter amount, i.e., €18,000 equals the difference in the fluctuations in value between the Yen and the Euro on the one hand and the Yen and the US Dollar on the other (i.e., 60,000 * 1.20 – 60,000 * 1.50). In addition, the amount of double tax relief granted with respect to the host state's share of the tax pie equals an effective relief of 20.3% as well.[398] Accordingly, the home state effectively recognizes a taxable Euro/Yen currency exchange result of €12,000 for tax purposes when branch B's profits of ¥60,000 are converted into €72,000 (i.e., 60,000 * 1.20). In addition, the host state effectively recognizes a taxable US Dollar/Yen currency exchange result of $30,000 when branch B's profits of ¥60,000 are converted into $90,000.

[389] 1 / 1.25 = 0.80.
[390] 1 / 1.50 = 0.67.
[391] 1 / (1 / 1.25) = 1.25.
[392] 1 / (1 / 1.50) = 1.50.
[393] 1 / (1.25 / 1.50) 1.20.
[394] 1.25 / 1.50 = 0.83.
[395] 25% * 112,000 = 28,000.
[396] (43,000 / 212,000) * 100% = 20.3%.
[397] (60,000 + 30,000) / (200,000 + 12,000) * 43,000 = 18,254.72.
[398] 18,254.72 / 90,000 * 100% = 20.3%.

Import neutrality promoting base exemption is distortive

If the home state were to have adopted an import neutrality promoting base exemption system, the payable home state tax would again have amounted to €25,000. That would substantially entail the levy of an effective tax at a rate of 20.5%,[399] instead of the above mentioned 19.7%.

Johnson would have run out of luck. The US Dollar decreased in value, whilst this fact would not have been taken into account for home state tax calculation purposes, indeed again on an arbitrary basis. The progressiveness moderating fact of Johnson's income being split alongside the home state and host state tax border would not have compensated for this. Things would even be worse if the host state branch B activities would have been loss-rendering.

3.5 The route to Rome; taxing the fraction

3.5.1 Had the Dutch tax legislator applied the Dutch style-double tax relief mechanism non-discriminatorily it would have enhanced fairness, but it did not…

3.5.1.1 The system itself operates equitably and efficiently as the tax burden is untouched by border crossages

Many other examples can be thought of that demonstrate the operation of the double tax relief mechanism. But the purpose of the aforementioned in-depth elaboration on the Dutch-style credit methodology's operation is to illustrate that the tax burden imposed in the home state remains the same, irrespective of whether resident taxpayer Johnson carries out its business activities in a cross-border context or not.

Due to its *pro rata parte* fractional operation, it neither acts a tax incentive nor a tax disincentive for taxpayer Johnson to cross the tax border vis-à-vis staying at home. The tax burden in the home state is not affected by such a decision. Accordingly, both the ability to pay principle and the benefits principle are respected concurrently. From a unilateral home state perspective the change of tax jurisdictions consequently takes place in a tax neutral and equitable manner.[400]

3.5.1.2 Common to international taxation practices, the system is however only available to Dutch resident taxpayers; non-resident taxpayers receive a different tax treatment

Unfortunately, the Netherlands reserves this equity and neutrality enhancing double tax relief mechanism for its resident taxpayers only. As a rule, its non-resident taxpayers are not granted access to the mechanism. The system applies only where the Netherlands is the home state. It does not apply where it is the host state. With that, the system is essentially applied in a discriminatory fashion.

As is the case with virtually all international tax systems, the Dutch international tax system typically distinguishes between resident taxpayers and non-resident taxpayers when calculating the tax charge. Resident taxpayers, i.e., persons who have their place of tax residence within the territories of the taxing state ('residence state'), are subject to unlimited tax liability and taxed on their worldwide income. In cases where resident taxpayers have eligible foreign source income items, juridical double tax relief is subsequently provided by means of the Dutch-style double tax relief method elaborated on in the above – the 'credit for domestic tax attributable to foreign income items'.

[399] 25,000 / (140,000 – 18,000) * 100% = 20.5%.
[400] Contra Court of Justice, cases C-279/93 (*Schumacker*) and C-385/00 (*De Groot*). Cf. B.J.M Terra et al, *European Tax Law* (2012), at Section 19.4.

Non-resident taxpayers, i.e., persons who have their place of tax residence outside the territories of the Netherlands ('source state') are treated differently. When the Netherlands is a host or source state the Dutch tax treatment is different. Non-resident taxpayers are subject to limited tax liability and are taxed on income derived from domestic sources only. To the extent that non-resident taxpayers derive foreign source income items, these items of income are not included in the source state's tax base. As foreign income is excluded from taxation in the source state (the Netherlands), these non-resident taxpayers' foreign source income items are substantially exempt from taxation in the respective source state (the Netherlands). Accordingly, as a host state 'double tax relief' is provided in a manner that is akin to the base exemption given by import neutrality promoting home states with respect to resident taxpayers with foreign source income (see 3.4.3.2). For reasons of convenience and conceptual reasons let's forward to the conclusion that by doing so the Netherlands provides for 'double tax relief' regarding the non-resident taxpayer's foreign income by way of a 'base exemption mechanism'.

It should be mentioned that this approach neatly fits the concepts and principles common in international taxation. The differential in the unlimited tax liability of resident taxpayers and the limited tax liability of non-resident taxpayers is the typical approach in the international tax regime. As already described above also the OECD Model Tax Convention shows evidence of embracing the differential in tax treatment depending on the taxpayer's place of residence.

3.5.1.3 Notwithstanding its alignment to international taxation, the difference in tax treatment is essentially unfair

Divergent tax treatment of resident taxpayers and non-resident taxpayers; for better or for worse

However, notwithstanding its acceptance in international taxation, non-resident taxpayers are not only materially and formally subject to different income tax treatment, they are also subject to a diverging tax burden in comparison with resident taxpayers. Compared to resident taxpayers, non-resident taxpayers may be worse off or better off depending on the facts and circumstances.

Sometimes the tax burden is lighter; income split effects

Non-resident taxpayers are, for example, subject to a more relaxed tax burden in cases involving 'income splits'. The fragmentation of a non-resident taxpayer's tax base across tax jurisdictions moderates any progressiveness effects in tax rate structures in the international tax system of the taxing jurisdiction involved. Viz., rather than on worldwide earnings non-resident taxpayers are subject to tax on their income to the extent that it is derived from domestic sources.

Mechanisms seeking to do justice to the progressiveness effects of tax rate structures, such as the internationally commonplace tax exemption with progression mechanisms – i.e., a *species* of the *generalis* base exemption – are typically only applied with respect to resident taxpayers who are unlimitedly subject to tax for their worldwide income. Non-resident taxpayers who derive income both from domestic and foreign sources may benefit from this difference in tax treatment. The effects of a non-resident taxpayer favoring income split have been addressed in section 4.1 above. Notably, under a strict territorial system, also resident taxpayers would benefit vis-à-vis the taxpayers that decided to stay at home, i.e., save for the application of a base exemption with progression mechanism.

Sometimes the tax burden is heavier

1 – No loss-imports, 2 – exit taxes, 3 – exemption of currency exchange results

Non-resident taxpayers may be worse off and be subject to a heavier tax burden in comparison with resident taxpayers. In practice, this may be the case regarding the tax treatment of cross-border losses, internal dealings and currency exchange results.

Ad 1 – No imports of losses from foreign investments

As a first example, take the scenario where a non-resident taxpayer suffers losses from cross-border business activities. Typically, non-resident taxpayers are excluded from the possibility to offset foreign source losses suffered against domestic source profits while such a 'horizontal' loss set-off possibility is typically available in cases where the items of income would have been derived within the same taxing jurisdiction.

It is not too uncommon that nation states enable their resident taxpayers to horizontally offset foreign source losses against domestic source profits – e.g. the Netherlands,[401] and Austria.[402] Notably, if the home state were to adopt a territorial system it would comparatively give a favorable tax treatment to the taxpayer that decided to stay at home vis-à-vis the taxpayer that decided to cross the tax border. By disabling foreign source loss imports, territorial systems distort outbound investment.

The distortive effects have been demonstrated in the above section 3.4.2. Non-resident taxpayers who suffer losses abroad are dependent on local (i.e., foreign) vertical loss set-off possibilities. Consequently non-resident taxpayers are put in a disadvantageous tax position – a liquidity disadvantage at best – in comparison with taxpayers who have been allowed to horizontally offset any losses suffered against the profits derived.[403] If our taxpayer Johnson were to have resided for instance in Brussels, Cologne, Rome, Beijing, or Washington for Dutch tax purposes, it would have been impossible to deduct Belgian source losses from its Dutch state tax base. Solely because of its foreign tax residency.

And, as also said, the Netherlands does not stand alone in this respect. Virtually all international tax systems of states subject non-resident taxpayers to this difference in tax treatment with the abovementioned consequence of the non-deductibility of foreign losses.

Ad 2 – Exit taxes upon outbound movements of property

The second example of a heavier tax burden imposed on taxpayers crossing the tax border vis-à-vis those staying at home is the levy of an 'exit tax' – i.e., a latent tax claim on a hidden reserve which immediately becomes due upon transfers of property from the respective taxing state's territories to another country. No such exit tax is typically levied upon the movement of property within the territories of that state.

It is not uncommon for nation states – e.g. the Netherlands – to refrain from imposing such an exit tax in cases where resident taxpayers transfer property containing a hidden reserve to another country.[404] Well, that is at least to the extent that these resident taxpayers do not also

[401] See for some details, Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international (*2011), at section 2.3.

[402] See Sec. 2(2) of the Austrian Income Tax Code (Einkommensteuergesetz, EStG). The Austrian Supreme Administrative Court (Verwaltungsgerichthof, VwGH) explicitly ruled that resident taxpayers may offset foreign sources losses against their domestic source profits, also in cases where a double tax convention applies providing for the exemption mechanism for double tax relief purposes; VwGH, 25 September 2001, 99/14/0217. A recapture rule (Nachversteuerung) applies to secure single taxation of cross-border business income; Sec. 2(8)(3) EStG.

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

[404] In the Netherlands, for example, latent income tax claims on hidden reserves do not become immediately due when resident taxpayers transfer capital assets from Dutch territory to another country. Instead, the hidden reserve is substantially added to the domestic taxable base in yearly instalments, which vary in directly proportion to the annual depreciation during the remaining economic lifetime of the transferred asset. Technically, the assets transferred from the Dutch head office to the foreign permanent establishment ('PE') are placed on the PE's balance sheet at fair value rather than the (lower) tax bookkeeping value. Subsequently, for the purpose of determining the PE's tax exempt profit, the annual (tax deductible) depreciation is calculated against that fair value (instead of the tax bookkeeping value). Accordingly, this leads to an annual reduction of the tax-exempt PE income for a period that corresponds with the remaining economic lifetime of the respective transferred asset. In addition, this leads to an

transfer their tax residence to another country as well.[405] This has been demonstrated in the above section 3.4.3.

Ad 3 – Exemption of currency exchange results from foreign investments

As a third example of a heavier, i.e., at least an arbitrary additional tax burden is the exemption of currency exchange results from the tax base. As non-resident taxpayers are merely subject to tax to the extent of income derived from domestic sources, currency exchange results realized by non-resident taxpayers' on income items earned on outward bound investments, i.e., as seen from the perspective of the source state, are exempt from the source state's tax base.

Consequently, just as is the case with the adoption of an import neutrality promoting base exemption mechanism, the tax burden imposed by source states to non-resident taxpayers is arbitrary as it disregards economically substantive income items for tax calculation purposes. Whether the tax burden moves in a favorable or unfavorable direction for the individual non-resident taxpayer has been left to a game of chance or speculation. Consequently, the decision to take business cross-border is affected by the tax system.

The application of a base exemption in respect of a non-resident taxpayer's foreign source income items and, with that, the exemption of currency exchange results from the tax base is akin to the German exemption of currency exchange losses regarding German resident taxpayers ruled incompatible with the fundamental freedoms by the Court of Justice in *Deutsche Shell*. In order to acknowledge this comparison it should be appreciated that a different place of residence does not entail that all of a sudden currency exchange results arise in another taxing jurisdiction. This is not the case. The mere difference is a difference in place of residence, not a difference in the location where the currency exchange results arises. Moreover, within the context of a borderless global market a difference in residence should not be considered a difference in circumstances.

Divergent tax treatment is based on a sole ground: the tax place of residence

The difference in tax treatment of non-resident taxpayers vis-à-vis resident taxpayers is founded on the sole ground of the place of residence for tax purposes. The question of whether such an unequal tax treatment should actually be considered to be fair has not often been addressed in the international tax literature.[406] In itself, this may be considered remarkable. Namely, one may ask oneself whether this unequal treatment of taxpayers that is

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increase in the corporate tax annually payable at the level of the head office during that same period. See Dutch Supreme Court, Hoge Raad, 12 February 1964, No. 15 068, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1964/95 (*Hopperzuiger*).

[405] Reference should be made to the ruling of the Court of Justice in case C-371/10 (*National Grid Indus*). *National Grid Indus* involved such an exit tax levied by The Netherlands upon an outbound movement of a production factor. The Court of Justice considered the exit tax compatible with the free movements provided that it is coupled with the possibility to opt for an interest bearing deferral of the tax collection. It should be noted that an immediate collection of the tax or an interest bearing deferral of the tax collection is equivalent in terms of the net present value worth of the tax debt imposed. Accordingly, the court ruling may be considered to be understood as effectively sanctioning the imposition of exit taxes under primary European Union law. This is quite difficult to understand conceptually. The idea of the internal market without internal frontiers is that the tax burden imposed by a single European Union Member State in a cross-border environment should be identical to that in an equivalent domestic environment. And this exactly was the problem in the case at hand. The exit tax imposed upon the outward bound border-crossing while no such a tax impost arises in the purely domestic equivalent case renders the outward movement to bear a comparatively higher burden relative to its domestic counterpart. This contradicts the rationale of the internal market without internal frontiers. It follows that – instead of approving it – the Court of Justice should have ruled the Dutch exit tax incompatible with the fundamental freedoms. See for a comparison, Court of Justice, case C-164/12 (*DMC Beteiligungsgesellschaft*) in which the Court dealt with a German exit tax in a somewhat similar matter.

[406] Noticeable exceptions are Frans Vanistendael, 'Tax revolution in Europe: the impact of non-discrimination', 40 *European Taxation* 3 (2000), Kees Van Raad (who referred to the subject in the context of the income taxation of individuals), in Kees van Raad, 'Non-Residents – Personal Allowances, Deduction of Personal Expenses and Tax Rates', 2 *World Tax Journal* 154 (2010), at 154-161, Cornelis van Raad, 'Fractional Taxation of Multi-State Income of EU Resident Individuals – A Proposal', in Krister Andersson et al (eds.), *Liber Amicorum Sven-Olof Lodin: Modern Issues in the Law of International Taxation - Series on International Taxation v. 27* (2001) 211, at 211-221, and Kees van Raad, 'Non-discriminatory Income Taxation of Non-resident taxpayers by Member States of the European Union: a Proposal', 26 *Brooklyn Journal of International Law* 1481 (2000-2001), at 1481-1492. Notably, Terra and Wattel seem to move in a similar direction as well. See B.J.M Terra et al, *European Tax Law* (2012), at 26.

solely based on their place of residence is compatible with the fundamental freedoms in those cases covered by the Treaty on Functioning of the European Union. After all, on many occasions the Court of Justice has ruled that a difference in tax treatment – where taxpayers make use of their fundamental freedoms – on the basis of that taxpayer's place of tax residence infringes primary European Union law.[407]

Why would such a difference in the tax treatment often established in the first few paragraphs of a typical country's tax code which provide for a taxpayer's limited or unlimited liability to tax, escape an equal treatment test? I fail to see why such income tax provisions deserve some kind of special status in this respect. It seems to me that this unequal tax treatment of non-resident taxpayers, solely on the basis of their place of residence, survived in international taxation just long enough to have become a tenet, a truism, based on nothing but its own merits, the fairness of which is no longer discussed in any way, shape, or form.

Seen from the perspective of a borderless global market, or at least from the perspective of the internal market without internal frontiers, such differences in tax treatment between resident and non-resident taxpayers should not occur. In a European Union law context, this encroaches upon the 'market access principle' and the 'market equality principle'. Such unilaterally imposed differences in tax burdens imposed entail market distortions and unjustified unequal treatment and, hence, should not occur.

The Court of Justice was essentially right in Renneberg

Observing things from that angle, perhaps the ruling of the Court of Justice in *Renneberg* is not that odd. In *Renneberg*, the Court of Justice essentially held that a difference in tax treatment between resident taxpayers and non-resident taxpayers is incompatible with the fundamental freedoms. I can only agree, as a difference in tax treatment on the sole ground of the taxpayer's place of residence is plainly indirectly discriminatory.

Notably, in my view, conceptually it makes no difference that the *Renneberg* case dealt with a Belgian resident individual who due to his fiscal domicile was entitled to the Dutch tax subsidy for his Belgian private dwelling. Insofar as the interpretation of the fundamental freedoms is concerned, the Court of Justice is not a tax court. Rather, it may be characterized as a constitutional court reviewing the interpretation and assessment of the legal implications in the European Union Member States of undertaking activities or economic activities in an intra-European Union, cross-border context, in view of the European Union equality principle.

Notably, I further fail to see why it should make a difference in direct tax related cases whether the taxpayer involved is a private individual or a corporate body having legal personality. Moreover, the question of whether the non-deductibility of certain expenditures due to the taxpayers' tax residency abroad involves a 'tax subsidy' also seems irrelevant to me.

At the end of the day, all that matters is the application of the equality principle. Are economic equal circumstances being treated unequally by European Union Member States for tax purposes (or vice versa)? If so, such a difference in tax treatment (in cases falling within the confines of the Treaty on Functioning of the European Union) encroaches upon the fundamental freedoms where the differences in tax treatment result in different tax burdens. And this currently is the case in basically all European Union Member States and virtually all other States.

[407] See for instance Court of Justice, cases C-527/06 (*Renneberg*), C-170/05 (*Denkavit Internationaal*), C-307/97 (*Saint Gobain*), C-311/97 (*RBS*) and 270/83 (*Commission v. France*). It should be noted that the Court of Justice has not adopted a consistent line of reasoning in this matter and decided otherwise in cases C-250/95 (*Futura*), C-414/06 (*Lidl*) and C-337/08 (X *Holding*). This is further discussed in section 6 of this chapter.

3.5.2 The difference in tax treatment of resident taxpayers and non-resident taxpayers should end

3.5.2.1 So what we need is…

Consequently, it seems that the fairness enhancing double tax relief system should not only apply to resident taxpayers, but its application should also be extended to non-resident taxpayers. In my view the issue not only involves the Dutch international tax system. Essentially, it involves all nation states international tax systems worldwide. In today's globalizing market no real economic difference exists between the internal market without internal frontiers and the global market. Tax border crossings of economic operators or their economic operations should not produce different tax burden within the international tax system of the taxing nation state. That would be internally unfair as it is inequitable and inefficient.

The point I wish to make is the following. Section 3.4 illustrates that the Dutch double tax relief mechanism enhances fairness within an international tax system. The system conceptually trumps territorial taxation systems, worldwide taxation/base exemption systems as well as worldwide taxation/tax credit systems provided it is employed in a non-discriminatory fashion. As it currently is not, the mechanism's application should be extended apply to all taxpayers irrespective of their place of residence. The double tax relief mechanism in the Dutch international tax system is reserved for resident taxpayers only. Non-residents are subject to a distortive territorial tax system as is the case in the current application of basically all international tax systems of nation states worldwide. So that is the problem that should be resolved by thinking of an equitable and tax neutral alternative. That would be worldwide taxation in conjunction with the Dutch-style tax exemption.

3.5.2.2 … unlimited tax liability upon domestic nexus and Dutch-style double tax relief for foreign nexus

The building blocks emerge

The building blocks of an internally fair international tax system start to emerge. Fairness within an international tax system requires that:

- Each economic operator with an economic presence in a taxing jurisdiction is subject to an unlimited tax liability. That taxpayer would accordingly be taxed on its worldwide business income. Its place of residence would then become irrelevant for corporate tax purposes. The approach is completely non-discriminatory.
- The fiscal sovereignty of states and the principle of single taxation would subsequently be honored by granting double tax relief with respect to the foreign income. The double tax relief would be granted under the mechanism referred to in this study as the 'credit for domestic tax attributable to foreign income' – i.e., the Dutch-style double tax relief mechanism. The geographical location of the taxpayer's income items would become irrelevant for corporate tax burden calculation purposes within the taxing state. The double tax relief mechanism would operate completely neutral.

Only this approach would bring fairness to the international tax system of a single nation state. Cross-border movements of economic operators and their operations would not affect the corporate tax burden imposed by that state. The application of this methodology would cancel out all discriminatory differences in tax treatment between resident and non-resident taxpayers as currently in place in the international corporate tax systems of states. Moreover, it would cancel out all restrictive differences in tax treatment between taxpayers moving their business activities between the respective domestic markets of states and taxpayers maintaining their business activities within the domestic market of a single state. In this way, the foreign source income of taxpayers is kept outside the domestic tax base in an equitable and economically efficient manner. The obstacles as defined in Chapter 1 of this study would be gone.

Introducing the 'thought experiment' to illustrate the internal consistency of the system

Things become evident if one imagines that the exact same methodology were to apply at both sides of the tax border – cancelling out the disparities. Were the same mechanism to apply at both sides of the tax border, the systems operating in conjunction would act like communicating vessels. This effect would be that border-crossings of taxpayers or their production factors would effectively not alter the tax burden. And with that, the advocated system proves to enhance an equitable and tax neutral division of taxing powers.

Indeed, these analytical steps require a fundamental change in the way of thinking on the concepts of source combined with territorial taxation (limited tax liability) and residence combined with worldwide taxation (unlimited tax liability) in the field of international taxation today. The effects are further explored in subsection 3.5.3 below. Again numerical examples referring to Johnson's dinghies will be used for clarification purposes. The difference will be the introduction of the system at the opposite side of the tax border, i.e., the reverse situation.

3.5.3 The operation of the advocated system; taxing the fraction

3.5.3.1 The tax burden is exactly the same in both domestic and cross-border environments

What would the effect be if the advocated fractional approach were to be adopted? What if states would subject all corporate taxpayers with income from sources in domestic sources to unlimited tax liability? What if all corporate taxpayers deriving income from domestic sources in each state in which it operates economic activities – irrespective of whether these taxpayers reside for tax purposes outside or within the territories of the respective taxing state – would be subject to tax in that state for their worldwide income? And what if all these states would subsequently provide for juridical double tax relief with respect to these taxpayers' foreign source income items under the 'credit for domestic tax attributable to foreign income'?

Let us do the thought experiment. It is assumed that there are no disparities and that all international tax systems have adopted the same international tax system and same approaches towards the taxable entity, the tax base and the tax rate.[408] Furthermore, it is assumed that all international tax systems follow the advocated approach, i.e., subject all resident and non-resident taxpayers to unlimited income tax liability while providing for double tax relief under the Dutch-style 'tax exemption' method. Moreover, it is assumed that the international tax regime that resulted from the 1920s Compromise operates adequately in capturing the geographic location of the income produced.

Then, the outcome would be that the tax burden imposed is exactly the same in both domestic and cross-border scenarios, i.e., regarding all proceeds derived from cross-border business activities.

- *Discrimination would be gone*. It would become immaterial in which state corporate taxpayers reside. The corporate tax treatment of a cross-border business activity would be exactly the same vis-à-vis the tax treatment of a non-cross-border activity. With respect to corporate taxation, it would be immaterial where the taxpayer resides. The tax burden imposed would be identical. No difference would exist. All direct and indirect discrimination or obstacles in the international tax systems of countries would be eliminated.

- *Restrictions would be gone*. It would be immaterial whether the corporate taxpayer performs its business in a cross-border context or purely domestic environment. All restrictions or obstacles in the international tax systems of countries would be eliminated. The unilaterally imposed tax burden would be the same in both domestic

[408] The approach taken accordingly adheres analytically to the internal consistency test as applied under US constitutional law.

and cross-border environment. Differences in tax burdens unilaterally imposed upon the crossing of tax borders would fade out to nil.

The crossing of tax borders within the emerging global market would not be hindered whatsoever. Fairness in the allocation of corporate tax among taxpayers and between states would be achieved. Within the context of the European Union, the approach as advocated in this study would provide the desired equilibrium between the tax sovereignty of the European Union Member States and the internal market without internal frontiers.[409] The approach would be completely non-discriminatory and tax-neutral and appreciate the European Union's fundamental freedoms to their fullest extent.

The way in which the system as advocated would operate may be illustrated by means of numerical examples. Let us for that purpose refer back to the tax positions of Johnson in the 'Base Case' and the variations put forward in the previous section under the additional assumption that the same approach is adopted on both sides of the tax borders of the states involved.

3.5.3.2 Communicating vessels: foreign and domestic source losses; cross-border loss set-off

With respect to the tax treatment of cross-border losses, the mutual operation of the 'recapture of foreign losses' and 'carry forward of foreign profits' mechanisms at both sides of the tax border would operate as communicating vessels. Where one state allows recapture, the other state allows a carry forward. And vice versa.

To clarify this, let us return to our taxpayer Johnson. Note that his place of residence has become irrelevant. Similar to the Base Case scenario, Johnson operates its dinghy trading activities through branches a) and b). Johnson is now subject to unlimited tax liability in both the home state and the host state due to its nexus in both states. And let us suppose that similar to the scenario in 3.4.2.2, taxpayer Johnson suffers a loss from the activities carried on through branch B in year 1. The loss adds up to €60,000. Moreover, let us assume that taxpayer Johnson, again similar to the scenario in 3.4.2.2, manages to derive a profit from its branch B of €80,000 in year 2.

The effects may be best demonstrated by using tables.

- *Figure 12. 'domestic scenario – loss set-off'* deals with the case that both taxpayer Johnson's branches of activities are situated within the territories of one state, say the home state, i.e., the Netherlands in the current example.
- *Figure 13. 'cross-border scenario – cross-border loss set-off'* deals with the case where taxpayer Johnson's branches A and B are situated across the territories of different states. Say, branch A is situated in what has been referred to as the home state, and branch B is situated in what has been referred to as the host state, i.e., the Netherlands and Belgium respectively.

Please note that the designation of the countries involved as 'home state' and 'host state' have now lost their analytical significance as the tax treatment in both countries involved has become identical.

Fig. 12. 'domestic scenario – loss set-off'

Taxpayer Johnson	**Year 1**

[409] Contra Weber in Dennis M. Weber, *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC* (2006), at 11-18. Weber shows evidence of favoring an import neutrality promoting territorial system. By pointing at the Court of Justice's ruling in case C-250/95 (*Futura*), Weber argues that unilaterally imposed market distortions resulting from European Union Member States expressing the territoriality principle in their international tax systems are disparities. I respectfully disagree. The distortions imposed re outbound investment under territorial tax systems are the result of unilateral legislative activity rather than the product of mutually diverging internally neutral international tax systems of the respective countries involved. It follows that these distortions analytically cannot be considered the consequence of disparate tax systems.

Income branch A in NL Income branch B in NL On balance	140,000 <60,000> **80,000**
Tax due in NL (under brackets as in fig. 7)	11,000
Tax burden imposed by NL	**13.8%**

Taxpayer Johnson	**Year 2**
Income branch A in NL Income branch B in NL On balance	140,000 80,000 **220,000**
Tax due in NL (under brackets as in fig. 7)	45,000
Tax burden imposed by NL	**20.5%**

Fig. 13. 'cross-border scenario – cross-border loss set-off'

Taxpayer Johnson (Year 1)	**Domestic income**	**Worldwide income**	**Income tax before double tax relief**	**Credit for domestic tax attributable to foreign income**	**Recapture foreign losses (admin. notice)**	**Carry forward foreign profits (admin. notice)**	**Income tax after double tax relief**	**Tax burden after double tax relief**
Tax position in NL	140,000	80,000	11,000	0	60,000	0	11,000 *(i.e., tax due in NL)*	n/a
Tax position in Belgium	<60,000>	80,000	11,000	11,000[410]	0[411]	60,000	0 *(i.e., tax due in Belgium)*	n/a
On balance	**80,000**	80,000	11,000	n/a	n/a	n/a	11,000 *(i.e., overall corporate tax due)*	**13.8%**[412] *(i.e., overall tax burden imposed*)

Taxpayer Johnson (Year 2)	**Domestic income**	**Worldwide income**	**Income tax before double tax relief**	**Credit for domestic tax attributable to foreign income**	**Recapture foreign losses**	**Carry forward foreign profits**	**Income tax after double tax relief**	**Tax burden after double tax relief**
Tax position in NL	140,000	220,000	45,000	4,090.91[413]	0	0	40,909.09[414] *(i.e., tax due in NL)*	n/a
Tax position in Belgium	80,000	220,000	45,000	40,909.09[415]	0	0	4,090.91[416] *(i.e., tax due in Belgium)*	n/a
On balance	**220,000**	220,000	45,000	n/a	n/a	n/a	45,000 *(i.e., overall corporate tax due)*	**20.5%**[417] *(i.e., overall tax burden imposed)*

As illustrated in the above tables, the tax burden on taxpayer Johnson's income is identical in both the domestic (solely Dutch) and cross-border (intra-European Union, i.e., in the current example the Belgian-Dutch) scenario under the advocated approach. In both scenarios the

[410] 80,000 / 80,000 * 11,000. The fraction is maximized at 1 (80,000/80,000 instead of 140,000 / 80,000) as Belgium would otherwise refund the tax in cash to Johnson. The excess of 60,000 (i.e. the excess foreign profit calculated at 140,000 – 80,000) is carried forward to the next year under the carry forward of foreign profits mechanism.
[411] 11,000 – 11,0000 = 0.
[412] 11,000 / 80,000 * 100% = 13.8%.
[413] (80,000 – 60,000) / 220,000 * 45,000 = 4,090.91.
[414] 45,000 – 4,090.91 = 40,909.09.
[415] (140,000 + 60,000) / 220,000 * 45,000 = 40,909.09.
[416] 45,000 – 40,909,09 = 4,090.91.
[417] 45,000 / 220,000 * 100% = 20.5%.

tax due would equal €11,000 in year 1 and €45,000 in year 2. The average effective tax rates in both the domestic and the cross-border scenario are identical as well. The rate effectively is 13.8% in year 1 and 20.5% in year 2.

Accordingly, under the assumed circumstances, i.e., the absence of disparities it has become completely irrelevant in which nation state taxpayer Johnson has its place of residence for tax purposes. Johnson may migrate to whichever nation state he chooses. The tax burden imposed, in this case by the Netherlands and Belgium, would not alter as a consequence.

It has also become irrelevant whether Johnson performs its business activities solely in one nation state, in this case the Netherlands, or whether its activities are spread across various nation states, in the current example the Netherlands and Belgium. Johnson may decide to open another dinghy trading business in any other nation state without the consequence of losing horizontal loss set-off entitlements. Taxing principles are distributed equitably.

Hence, Johnson and its operations – to the extent that it concerns the levy of corporate taxation – can move completely unhindered between the states' national markets. That is, to the extent that it concerns the matter of cross-border loss compensation. The outcome coincides with the envisaged elimination of unilaterally imposed tax obstacles within the emerging global market as well as the internal market without internal frontiers within the European Union. To that end, fair (equitable, i.e., non-discriminatory) and free (economically efficient, i.e., tax neutral) competition within the internal market would be enabled.[418] Viz., changing tax jurisdictions would not alter the tax burden. Movements of economic operators/taxpayers and their operations/production factors/sources of income within the internal market are therefore not affected/distorted. This seems tax neutral to me.

Interestingly, this holds true with respect to both the inward-bound movements ('import') and outward-bound movements ('export') of the production factors capital, labor and enterprise. The advocated approach hence simultaneously promotes both capital and labor import neutrality and capital and labor export neutrality.

Effects in a multiple country scenario; introducing a third country into the equation

Notably, in a multiple-country scenario the loss-imports and subsequent recapture obligations and carry forward entitlements would need to be distributed among the countries involved in proportion to the attribution of taxable base. That is to secure a single taxation of the taxable base.

Let us return to our taxpayer Johnson to clarify how such a proportional attribution of the recapture mechanism and carry forward mechanism would operate. A third branch is put into the equation, branch C. Let us suppose that, in addition to the facts and circumstances in the previous scenario, Johnson now operates its dinghy trading activities at three locations, through branches A, B, and the newly introduced branch C. The profits Johnson derives from branch A in years 1 and 2 are similar to those in the previous scenario. Let us further suppose that taxpayer Johnson, again, suffers a loss from its activities carried on through branch B in year 1. As in the previous scenario, the loss adds up to €60,000. Moreover, let us assume that taxpayer Johnson, again similar to the previous scenario, manages to derive a profit from its branch B of €80,000 in year 2. Let us further assume that Johnson derives a profit from its branch C in both taxable years. The profit realized through its branch C equal €100,000 in both years.

The effects may be best demonstrated by using tables.

[418] In the event that our taxpayer Johnson would emigrate abroad, the taxing jurisdiction from which Johnson would emigrate should be enabled to adopt the administrative measures needed to ensure the effective taxation of any commercial benefits derived from domestic sources at some later moment in time (e.g. the realization of a hidden reserve subsequent to the emigration abroad). This is not further discussed.

- *Figure 12a. 'domestic scenario – loss set-off'* deals with the case that all taxpayer Johnson's branches of activities are situated within the territories of one state, i.e., the Netherlands in the current example.
- *Figure 13a. 'cross-border scenario – cross-border loss set-off'* deals with the case where taxpayer Johnson's branches A, B, and C are situated across the territories of different states. Branches A, B, and C are situated in the Netherlands and Belgium. The newly introduced branch C is situated in Germany.

Fig. 12a. 'domestic scenario – loss set-off''

Taxpayer Johnson	**Year 1**
Income branch A in NL	140,000
Income branch B in NL	<60,000>
Income branch C in NL	100,000
On balance	**180,000**
Tax due in NL (under brackets as in fig. 7)	35,000
Tax burden imposed by NL	**19.4%**

Taxpayer Johnson	**Year 2**
Income branch A in NL	140,000
Income branch B in NL	80,000
Income branch C in NL	100,000
On balance	**320,000**
Tax due in NL (under brackets as in fig. 7)	70,000
Tax burden imposed by NL	**21.9%**

Fig. 13a. 'cross-border scenario – cross-border loss set-off'

Taxpayer Johnson (Year 1)	**Domestic income**	**Worldwide income**	**Income tax before double tax relief**	**Credit for domestic tax attributable to foreign income**	**Recapture foreign losses (admin. notice)**	**Carry forward foreign profits (admin. notice)**	**Income tax after double tax relief**	**Tax burden after double tax relief**
Tax position in NL	140,000	180,000	35,000	14,583.33[419]	35,000[420]	0	20,416.67 *(i.e., tax due in NL)*	n/a
Tax position in Belgium	<60,000>	180,000	35,000	35,000[421]	0[422]	60,000[423]	0 *(i.e., tax due in Belgium)*	n/a
Tax position in Germany	100,000	180,000	35,000	20,416.67[424]	25,000[425]	0	14,583.33 *(i.e., tax due in Germany)*	n/a
On	**180,000**	180,000	35,000	n/a	n/a	n/a	35,000	**19.4%**[426]

[419] (100,000 – 60,000 + 35,000) / 180,000 * 35,000 = 14,583.33. The branch C profit of 100,000 is reduced with the branch B loss that is proportionally attributable to The Netherlands in the current example. The proportional loss-import amount is calculated by reference to the domestic income to worldwide proceeds ratio (140,000 / 240,000 * 100% = 58.3%). Accordingly, the apportioned loss-import amount equals 35,000 (140,000 / 240,000 * 60,000).
[420] 140,000 / 240,000 * 60,000 = 35,000.
[421] 180,000 / 180,000 * 35,000 = 35,000. The fraction is maximized at 1 (180,000 / 180,000 instead of 240,000 / 80,000) as Belgium would otherwise refund the tax in cash to taxpayer Johnson. The excess of 60,000 (i.e., the excess foreign profit calculated at 240,000 – 180,000) is carried forward to the next year under the carry forward of foreign profits mechanism.
[422] 35,000 – 35,000 = 0.
[423] The amount carried forward equals the branch B loss of 60,000. The carry forward amount relating to the loss-import amount apportioned to The Netherlands equals 35,000 (140,000 / 240,000 * 60,000). The carry forward amount relating to the loss-import amount apportioned to Germany equals 25,000 (100,000 / 240,000 * 60,000 = 25,000).
[424] (140,000 – 60,000 + 25,000) / 180,000 * 35,000 = 20,416.67. The branch A profit of 140,000 is reduced with the branch B loss that is proportionally attributable to Germany in the current example. The loss-import amount is calculated by reference to the domestic income to worldwide proceeds ratio (100,000 / 240,000 * 100% = 41.6%). Accordingly, the apportioned loss-import equals 25,000 (100,000 / 240,000 * 60,000).
[425] 100,000 / 240,000 * 60,000 = 25,000.

balance							*(i.e., overall corporate tax due)*	*(i.e., overall tax burden imposed*)

Taxpayer Johnson (Year 2)	**Domestic income**	**Worldwide income**	**Income tax before double tax relief**	**Credit for domestic tax attributable to foreign income**	**Recapture foreign losses**	**Carry forward foreign profits**	**Income tax after double tax relief**	**Tax burden after double tax relief**
Tax position in NL	140,000	220,000	70,000	31,718.75[427]	0	0	38,281.25[428] *(i.e., tax due in NL)*	n/a
Tax position in Belgium	80,000	220,000	70,000	65,625[429]	0	0	27,343.75[430] *(i.e., tax due in Belgium)*	n/a
Tax position in Germany	100,000	100,000	70,000	42,656.25[431]	0	0	4,375[432] *(i.e., tax due in Germany)*	n/a
On balance	**320,000**	320,000	70,000	n/a	n/a	n/a	70,000 *(i.e., overall corporate tax due)*	**21.9%**[433] *(i.e., overall tax burden imposed)*

The calculations reveal that the observations set forth in the above paragraphs do not alter in a multiple country scenario. As illustrated in the tables above, the tax burden imposed on taxpayer Johnson's income, again, is identical in both the domestic (solely Dutch) and cross-border (intra-European Union, i.e., in the current example the Belgian-Dutch-German) scenario under the advocated approach. In both scenarios the tax due would equal €35,000 in year 1 and €70,000 in year 2. The average effective tax rates in both the domestic and the cross-border scenario are identical as well. The rate effectively is 19.4% in year 1 and 21.9% in year 2.

3.5.3.3 Communicating vessels: notional services provided, notional supplies of goods (stock and capital assets)

If the advocated approach is applied at both sides of the tax border, the mechanisms in their mutual operation at both sides of the tax border produce a system that operates as communicating vessels in respect of notional services provided, notional supplies of goods and notional capital asset transfers. Where one state recognizes an increase in the double tax relief granted, the other state recognizes a decrease; and vice versa. This effect may also be clarified through numerical examples.

Intra-firm provisions of services

Let us return to the scenario referred to in section 3.4.3.2 through 3.4.3.4. As mentioned, one of taxpayer Johnson's workers in branch A renders an internal service for the benefit of the

[426] 35,000 / 180,000 * 100% = 19.4%.
[427] (80,000 + 100,000 – 35,000) / 320,000 * 70,000 = 31,718.75. The loss-import amount of 35,000 as apportioned to The Netherlands in year 1 is recaptured in year 2.
[428] 70,000 – 31,718.75 = 38,281.25.
[429] (140,000 + 100,000 + 60,000) / 320,000 * 70,000 = 65,625. The carried forward amount in year 1 is recognized for double tax relief purposes in year 2.
[430] 70,000 – 42,656.25 = 27,343.75.
[431] (80,000 + 140,000 – 25,000) / 320,000 * 70,000 = 42,656.25. The loss-import amount of 25,000 as apportioned to Germany in year 1 is recaptured in year 2.
[432] 70,000 – 65,625 = 4,375.
[433] 70,000 / 320,000 * 100% = 21.9%.

business activities carried on through branch B. The fair market value of the service rendered equals €15,000. Again, things are illustrated best through figures.

- *Figure 14. 'Domestic scenario – intra-firm provisions of services'* deals with the scenario that both taxpayer Johnson's branches of activities are situated within the territories of the Netherlands.
- *Figure 15. 'Cross-border scenario – intra-firm provisions of services'* deals with the case where taxpayer Johnson's branch A is situated in the Netherlands and branch B is situated in Belgium.

Fig. 14. 'Domestic scenario – intra-firm provisions of services'

Taxpayer Johnson	**Year X**
Income branch A in NL	140,000
'Added': notional service fee received by branch A	15,000
Income branch B in NL	60,000
'Deducted': notional service fee paid by branch B	<15,000>
On balance	**200,000**
Tax due in NL (under brackets as in fig. 7)	**40,000**
Tax burden imposed by NL	**20%**

Fig. 15. 'Cross-border scenario – intra-firm provisions of services'

Taxpayer Johnson (Year X)	**Domestic income**	**Worldwide income**	**Corporate tax before double tax relief**	**Credit for domestic tax attributable to foreign income**	**Corporate tax after double tax relief**	**Tax burden after double tax relief**
Tax position in NL	155,000[434]	200,000	40,000	9,000[435]	31,000[436] *(i.e., tax due in NL)*	20.0%[437] *(i.e., tax burden imposed by NL)*
Tax position in Belgium	45,000[438]	200,000	40,000	31,000[439]	9,000[440] *(i.e., tax due in Belgium)*	20.0%[441] *(i.e., tax burden imposed by Belgium)*
On balance	**200,000**	200,000	40,000	n/a	**40,000** *(i.e., overall corporate tax due)*	**20.0%**[442] *(i.e., overall tax burden imposed)*

Under the advocated approach the tax burden of taxpayer Johnson is the same in both the domestic and the cross-border scenario. In both cases, taxpayer Johnson would pay €40,000 corporate tax, an effective tax imposed at a 20% rate in both the Netherlands and Belgium. Again, it is irrelevant where Johnson has its place of residence for tax purposes. It is also irrelevant whether taxpayer Johnson performs its business activities solely in the Netherlands or spread across nation states, in this case the Netherlands and Belgium. Taxpayer Johnson and its business activities can move unhindered across-tax borders within the global market, while both the Netherlands and Belgium receive their fair share of the tax pie.

[434] 140,000 + 15,000 = 155,000.
[435] (60,000 – 15,000) / 200,000 * 40,000 = 9,000.
[436] 40,000 – 9,000 = 31,000.
[437] 31,000 / 155,000 * 100% = 20.0%.
[438] 60,000 – 15,000 = 45,000.
[439] (140,000 + 60,000) / 200,000 * 40,000 = 31,000.
[440] 40,000 – 31,000 = 9,000.
[441] 9,000 / 45,000 * 100% = 20%.
[442] 40,000 / 200,000 * 100% = 20%.

Intra-firm supplies of goods (stock transfers)

Let us return to the first scenario referred to in 3.4.3.3. As mentioned, a good (the dinghy) is produced through branch A, subsequently transferred to branch B from which it is sold on the market. As said the boat's manufacturing costs equal €5,000, its wholesale value is €12,000 and the resale price on which the boat is sold on the market equals €20,000.

- *Figure 16. 'Domestic scenario – intra-firm supplies of goods*' deals with the domestic scenario, i.e., both taxpayer Johnson's branches of activities are situated within the territories of the Netherlands.
- *Figure 17. 'Cross-border scenario – intra-firm supplies of goods*' deals with the cross-border scenario, i.e., the case where taxpayer Johnson's branch A is situated in the Netherlands and branch B is situated in Belgium.

Fig. 16. 'Domestic scenario – intra-firm supplies of goods'

Taxpayer Johnson	**Year X**
Income branch A in NL	140,000
'Added': notional consideration received by branch A upon intra-firm good supply	12,000
'Deducted': manufacturing costs.	<5,000>
Income branch B in NL	60,000
'Deducted': notional consideration paid by branch B upon intra-firm good supply	<7,000>
Added: sales price upon sale of good on market	15,000
On balance	**215,000**
Tax due in NL (under brackets as in fig. 7)	**43,750**
Tax burden imposed by NL	**20.3%**

Fig. 17. 'Cross-border scenario – intra-firm supplies of goods'

Taxpayer Johnson (Year X)	**Domestic income**	**Worldwide income**	**Corporate tax before double tax relief**	**Credit for domestic tax attributable to foreign income**	**Corporate tax after double tax relief**	**Tax burden after double tax relief**
Tax position in NL	147,000[443]	215,000	43,750	13,837.21[444]	29,912.79[445] *(i.e., tax due in NL)*	20.3%[446] *(i.e., tax burden imposed by NL)*
Tax position in Belgium	68,000[447]	215,000	43,750	29,912.79[448]	13,837.21[449] *(i.e., tax due in Belgium)*	20.3%[450] *(i.e., tax burden imposed by Belgium)*
On	**215,000**	215,000	43,750	n/a	**43,750**	**20.3%**[451]

[443] 140,000 + 7,000 = 147,000.
[444] (60,000 + 8,000) / 215,000 * 43,750 = 13,837.21.
[445] 43,750 – 13,837.21= 29,912.79.
[446] 29,912.79 / 147,000 * 100% = 20.3%.
[447] 60,000 + 8,000 = 68,000.
[448] (140,000 + 7,000) / 215,000 * 43,750 = 29,912.79.
[449] 43,750 – 29,912.79 = 13,837.21.
[450] 13,837.21/ 68,000 * 100% = 20.3%.

balance					*(i.e., overall corporate tax due)*	*(i.e., overall tax burden imposed)*

The tax burden of taxpayer Johnson is the same in both the domestic as the cross-border scenario. In both cases taxpayer Johnson would pay €43,750 corporate tax, a tax burden of 20.3%. Johnson's place of residence is irrelevant for tax purposes. The same is true with respect to the question of whether taxpayer Johnson performs its business activities solely in the Netherlands or spread across the Netherlands and Belgium. Accordingly, taxpayer Johnson can do business within the global market without being hindered whatsoever, while both the Netherlands and Belgium receive their fair share of the tax pie.

Intra-firm supplies of goods (capital asset transfers)

In the first scenario referred to in 3.4.3.4 a capital asset is transferred from branch A to branch B for the purpose of durably employing it for the benefit of Johnson's business operations carried on through its branch B. As said, it is assumed that the capital asset was acquired 5 years ago. Its acquisition price was €600,000, its economic lifetime 20 years, and that the yearly, tax deductible, depreciation is €30,000. In addition, it was mentioned that, at the moment prior to the notional capital transfer, the asset was placed at branch A's balance sheet at an amount of €450,000,[452] while at that time, its fair value equals to €500,000.

- *Figure 18. 'Domestic scenario – intra-firm capital asset transfers*' again deals with the domestic scenario.
- *Figure 19. 'Cross-border scenario – intra-firm capital asset transfers*' deals with the cross-border scenario.

Fig. 18. 'Domestic scenario – intra-firm capital asset transfers'

Taxpayer Johnson	**Year X**
Income branch A in NL	140,000
'Added': notional consideration received by branch A upon intra-firm asset transfer	500,000
Income branch B in NL	60,000
'Deducted': notional consideration paid by branch B upon intra-firm capital asset transfer	<500,000>
Deducted: depreciation capital asset upon capital asset transfer	<30,000>
On balance	**170,000**
Tax due in NL (under brackets as in fig. 7)	**32,500**
Tax burden imposed by NL	**19.1%**

Fig. 19. 'Cross-border scenario – intra-firm capital asset transfers'

Taxpayer Johnson (Year X)	**Domestic income**	**Worldwide income**	**Corporate tax before double tax relief**	**Credit for domestic tax attributable to foreign income**	**Corporate tax after double tax relief**	**Tax burden after double tax relief**
Tax	143,333.33[453]	170,000	32,500	5,098.04[454]	27,401.96[455]	19.1%[456]

[451] 43,750 / 215,000 * 100% = 20.3%.
[452] 600,000 – 5 * 30,000 = 450,000.
[453] 140,000 + 3,333.33 = 143,333.33.
[454] (60,000 – 33,333.33) / (200,000 – 30,000) * 32,500 = 5,098.04.
[455] 32,500 – 5,098.04 = 27,401.96.
[456] 27,401.96 / 143,333.33 * 100% = 19.1%.

position in NL					*(i.e., tax due in NL)*	*(i.e., tax burden imposed by NL)*
Tax position in Belgium	26,666.67[457]	170,000	32,500	27,401.96[458]	5,098.04[459] *(i.e., tax due in Belgium)*	19.1%[460] *(i.e., tax burden imposed by Belgium)*
On balance	**170,000**	170,000	32,500	n/a	**32,500** *(i.e., overall corporate tax due)*	**19.1%**[461] *(i.e., overall tax burden imposed)*

Again, the tax burden imposed is the same in both the domestic and the cross-border scenario. In both cases taxpayer Johnson would pay €32,500 corporate tax. The effective tax burden imposed would equal 19.1%. Neither the place of Johnson's residence nor the question of whether taxpayer Johnson performs its business activities in a cross-border setting is relevant for corporate tax purposes. This would enable taxpayer Johnson to do business within the global market without corporate taxation hindering this. Moreover, both the Netherlands and Belgium receive their fair share of the tax pie.

3.5.3.4 Currency exchange results

The proportional effects would also arise regarding the corporate tax treatment of currency exchange results realized. Again, things may be clarified through numerical examples.

Scenario (i) – US Branch B's tax books are kept in US Dollars

Let us, for this purpose, return to the cross-border scenario referred to in 3.4.4.2, i.e., scenario (i), case a). Taxpayer Johnson's branch A tax books are kept in Euro. The books of branch B are kept in the US Dollar. The Netherlands employs the Euro for corporate tax calculation purposes. State X, the United States of America employs the US Dollar for this purpose. The US Dollar increases in value during the tax booking period in a manner as referred to in 3.4.4.2. In figures:

- *Figure 20. 'Domestic scenario – NL – US Dollar rate increases – currency exchange results realized'* deals with the purely domestic scenario in which both branches are situated within Dutch territory;
- *Figure 21. 'Domestic scenario – USA – US Dollar rate increases – currency exchange results realized'* deals with the purely domestic scenario in which the branches are situated within USA territory, and;
- *Figure 22. 'Cross-border scenario – NL and USA – US Dollar rate increases – currency exchange results realized*' deals with the cross-border scenario, i.e., where branch A is situated within Dutch territory and branch B in United States' territory.

Fig. 20. 'Domestic scenario – NL – US Dollar rate increases – currency exchange results realized'

Taxpayer Johnson	**Year X**
Income branch A in NL	€140,000
Income branch B in NL	$60,000
Added: currency exchange result realized	€15,000
On balance	€215,000
Tax due in NL (under brackets as in fig. 7)	€43,750

[457] 60,000 – 33,333.33 = 26,666.67.
[458] (140,000 + 3,333.33) / (200,000 – 30,000) * 32,500 = 27,401.96.
[459] 32,500 – 27,401.96 = 5,098.04.
[460] 5,098.04 / 26,666.67 * 100% = 19.1%.
[461] 32,500 / 170,000 * 100% = 19.1%.

Tax burden imposed by NL	**20.3%**

Fig. 21. 'Domestic scenario – USA – US Dollar rate increases – currency exchange results realized'

Taxpayer Johnson	**Year X**
Income branch A in USA	€140,000
Deducted: currency exchange result realized	<$28,000>
Income branch B in USA	$60,000
On balance	$172,000
Tax due in USA (under brackets as in fig. 7)	$33,000
Tax burden imposed by USA	**19.2%**

Fig. 22. 'Cross-border scenario – NL and USA – US Dollar rate increases – currency exchange results realized'

Taxpayer Johnson (Year X)	**Domestic income**	**Worldwide income**	**Corporate tax before double tax relief**	**Average effective tax rate before double tax relief**	**Credit for domestic tax attributable to foreign income**	**Corporate tax after double tax relief**	**Tax burden after double tax relief**
Tax position in NL	€155,000[462]	€215,000[463]	€43,750[464]	20.3%[465]	€12,209.30[466]	€31,540.70[467] *(i.e., tax due in NL)*	**20.3%**[468] *(i.e., tax burden imposed by NL)*
Tax position in USA	$32,000[469]	$172,000[470]	$33,000[471]	19.2%[472]	$26,860.47[473]	$6,139.53[474] *(i.e., tax due in USA)*	**19.2%**[475] *(i.e., tax burden imposed by USA)*

Under the advocated approach, the tax burdens imposed by the Netherlands and the United States of America would be the same in both domestic and cross-border scenarios. The tax burden of Johnson in the Netherlands would equal 20.3% as a positive currency exchange result of €15,000 would have been realized. The United States of America would impose a 19.2% effective tax as a consequence of the currency loss of $28,000. Both the Netherlands and the United States of America would receive their fair share of the tax pie.

Notably, overall calculations are of no argumentative value at this point as the currency exchange results are calculated on different bases, i.e., the mutually diverging branch A and branch B profits. That is, at least since the tax base is defined by reference to a realization based nominal return to equity tax base standard at this place in this study. Currency risks cannot be influenced by taxpayers individually. The distortive effects of fluctuating currency exchange rates due to the presence of varying currencies in the global marketplace (monetary disparities) may only be resolved by means of monetary harmonization, i.e., a monetary union such as the European monetary union. For an overview of the effects of the advocated system regarding currency exchange results, i.e., where also the tax base and tax base allocation have been assessed; see section 4.5.3 of Chapter 6.

[462] 140,000 + 15,000 = 155,000.
[463] 140,000 + 60,000 + 15,000 = 215,000
[464] 5,000 + 10,000 + 0.25 * 115,000 = 43,750.
[465] 43,750 / 215,000 * 100% = 20.3%.
[466] 60,000 / (200,000 + 15,000) * 43,750 = 12,209.30.
[467] 43,750 – 12,209.30 = 31.540,70.
[468] 31,540.70 / 155,000 * 100% = 20.3%.
[469] 60,00 – 28,000 = 32,000.
[470] 140,000 – 28,000 + 60,000 = 172,000.
[471] 5,000 + 10,000 + 0,25 * 72,000 = 33,000.
[472] 33,000 / 172,000 * 100% = 19.1%.
[473] 140,000 / 200,000 – 28,000) * 33,000 = 26,860.47.
[474] 33,000 – 26,860.47 = 6,139.53.
[475] 6,139.53 / 32,000 * 100% = 19.2%.

In the *reverse situation* in which the US Dollar drops in value referred to in the above as scenario (i), case b), things would work out in the exact opposite manner. Again the tax burden imposed by the Netherlands and the United States of America is the same in both domestic and cross-border scenarios. In figures:

Fig. 23. 'Domestic scenario – NL – US Dollar rate decreases – currency exchange results realized'

Taxpayer Johnson	**Year X**
Income branch A in NL	€140,000
Income branch B in NL	$60,000
Deducted: currency exchange result realized	<€12,000>
On balance	€188,000
Tax due in NL (under brackets as in fig. 7)	€37,000
Tax burden imposed by NL	**19.7%**

Fig. 24. 'Domestic scenario – USA – US Dollar rate decreases – currency exchange results realized'

Taxpayer Johnson	**Year X**
Income branch A in USA	€140,000
Added: currency exchange result realized	<$35,000>
Income branch B in USA	$60,000
On balance	$235,000
Tax due in USA (under brackets as in fig. 7)	$48,750
Tax burden imposed by USA	**20.7%**

Fig. 25. 'Cross-border scenario – NL and USA – US Dollar rate decreases – currency exchange results realized'

Taxpayer Johnson (Year X)	**Domestic income**	**Worldwide income**	**Corporate tax before double tax relief**	**Average effective tax rate before double tax relief**	**Credit for domestic tax attributable to foreign income**	**Corporate tax after double tax relief**	**Tax burden after double tax relief**
Tax position in NL	€128,000[476]	€188,000[477]	€37,000[478]	19.7%[479]	€11,808.51[480]	€25,191.48[481] *(i.e., tax due in NL)*	**19.7%**[482] *(i.e., tax burden imposed by NL)*
Tax position in USA	$95,000[483]	$235,000[484]	$48,750[485]	20.8%[486]	$29,042.55[487]	$19,707.44[488] *(i.e., tax due in USA)*	**20.7%**[489] *(i.e., tax burden imposed by USA)*

Scenario (ii) – US Branch B's tax books are kept in Euro

[476] 140,000 – 12,000 = 128,000.
[477] 140,000 + 60,000 – 12,000 = 188,000.
[478] 5,000 + 10,000 + 0,25 * 88,000 = 37,000.
[479] 37,000 / 188,000 * 100% = 19.7%.
[480] 60,000 / (200,000 – 12,000) * 37,000 = 11,808.51.
[481] 37,000 – 11,808.51 = 25,191.48.
[482] 25,191.48 / 128,000 * 100% = 19.7%.
[483] 60,00 + 35,000 = 95,000.
[484] 140,000 + 35,000 + 60,000 = 235,000.
[485] 5,000 + 10,000 + 0,25 * 135,000 = 48,750.
[486] 48,750 / 235,000 * 100% = 20.7%.
[487] 140,000 / 200,000 + 35,000) * 48,750 = 29,042.55.
[488] 48,750 – 29,042.55 = 19,707.44.
[489] 19,707.44 / 95,000 * 100% = 20.7%.

If the tax books of both Dutch branch B and US branch A were kept in Euro while the US Dollar increases in value in a manner comparable to the case referred to in 3.4.4.3, scenario (ii), case c) the effects under the advocated approach would be as follows. In figures:

Fig. 26. 'Domestic scenario – NL – US Dollar rate increases – no currency exchange results realized'

Taxpayer Johnson	**Year X**
Income branch A in NL Income branch B in NL On balance	€140,000 €60,000 €200,000
Tax due in NL (under brackets as in fig. 7)	€40,000
Tax burden imposed by NL	**20.0%**

Fig. 27. 'Domestic scenario – USA – US Dollar rate increases – currency exchange results realized'

Taxpayer Johnson	**Year X**
Income branch A in USA Deducted: currency exchange result realized Income branch B in USA Deducted: currency exchange result realized	€140,000 <$28,000> $60,000 <$12,000>
On balance	$160,000
Tax due in USA (under brackets as in fig. 7)	$30,000
Tax burden imposed by USA	**18.8%**

Fig. 28. 'Cross-border scenario – NL and USA – US Dollar rate increases – currency exchange results realized'

Taxpayer Johnson (Year X)	**Domestic income**	**Worldwide income**	**Corporate tax before double tax relief**	**Average effective tax rate before double tax relief**	**Credit for domestic tax attributable to foreign income**	**Corporate tax after double tax relief**	**Tax burden after double tax relief**
Tax position in NL	€152,000[490]	€200,000[491]	€40,000[492]	20.0%[493]	€9,600[494]	€30,400[495] *(i.e., tax due in NL)*	**20.0%**[496] *(i.e., tax burden imposed by NL)*
Tax position in USA	$20,000[497]	$160,000[498]	$30,000[499]	18.75%[500]	$26,250[501]	$3,750[502] *(i.e., tax due in USA)*	**18.8%**[503] *(i.e., tax burden imposed by USA)*

Again, the tax burdens imposed by the Netherlands and the United States of America would be the same in both domestic and cross-border scenarios. The Netherlands would

[490] 140,000 + 12,000 = 152,000.
[491] 140,000 + 60,000 = 200,000.
[492] 5,000 + 10,000 + 0,25 * 100,000 = 40,000.
[493] 40,000 / 200,000 * 100% = 20.0%.
[494] (60,000 – 12,000) / 200,000 * 40,000 = 9,600.
[495] 40,000 – 9,600 = 30,400.
[496] 30,400 / 152,000 * 100% = 20.0%.
[497] 60,00 – 28,000 – 12,000 = 20,000.
[498] 140,000 + 60,000 – 28,000 – 12,000 = 160,000.
[499] 5,000 + 10,000 + 0,25 * 60,000 = 30,000.
[500] 30,000 / 160,000 * 100% = 18.8%.
[501] 140,000 / 160,000 * 30,000 = 26,250.
[502] 30,000 – 26,250 = 3,750.
[503] 3,750 / 20,000 * 100% = 18.8%.

consistently impose a tax at an effective rate of 20.0%. The United States of America would subject Johnson to a tax of 18.8%. Both the Netherlands and the United States of America would receive their fair share of the tax pie.

In the *reverse situation* in which the US Dollar drops in value referred to in the above as scenario (ii), case d), things would work out in the exact opposite manner. Again the tax burden imposed by the Netherlands and the United States of America is the same in both domestic and cross-border scenarios. I do not forward the non-discriminatory and neutral effects by means of a schedule. I respectfully dare the reader to determine these effects himself.

Scenario (iii) – US Branch B's tax books are kept in Japanese Yen

In the case in which the books of Dutch branch A are kept in Euro and those of US branch B in Yen, while the US Dollar increases in value in respect of both the Euro and the Yen in the same manner as referred to in 4.4.4, scenario (iii), case e), things would turn out as follows under the advocated approach. In figures:

Fig. 29. 'Domestic scenario – NL – US Dollar rate increases – currency exchange results realized'

Taxpayer Johnson	**Year X**
Income branch A in NL	€140,000
Income branch B in NL	¥60,000
Deducted: currency exchange result realized	<€10,000>
On balance	€190,000
Tax due in NL (under brackets as in fig. 7)	€37,500
Tax burden imposed by NL	**19.7%**

Fig. 30. 'Domestic scenario – USA – US Dollar rate increases – currency exchange results realized'

Taxpayer Johnson	**Year X**
Income branch A in USA	€140,000
Deducted: currency exchange result realized	<$28,000>
Income branch B in USA	¥60,000
Deducted: currency exchange result realized	<$20,000>
On balance	$152,000
Tax due in USA (under brackets as in fig. 7)	$28,000
Tax burden imposed by USA	**18.4%**

Fig. 31. 'Cross-border scenario – NL and USA – US Dollar rate increases – currency exchange results realized'

Taxpayer Johnson (Year X)	**Domestic income**	**Worldwide income**	**Corporate tax before double tax relief**	**Average effective tax rate before double tax relief**	**Credit for domestic tax attributable to foreign income**	**Corporate tax after double tax relief**	**Tax burden after double tax relief**
Tax position in NL	€150,000[504]	€190,000[505]	€37,500[506]	19.7%[507]	€7,894.74[508]	€29,605.26[509] *(i.e., tax due in NL)*	**19.7%**[510] *(i.e., tax burden*

[504] 140,000 + 10,000 = 150,000.
[505] 140,000 + 60,000 – 10,000 = 190,000.
[506] 5,000 + 10,000 + 0,25 * 90,000 = 37,500.
[507] 37,500 / 190,000 * 100% = 19.7%.
[508] (60,000 – 20,000) / (200,000 – 10,000) * 37,500 = 7,894.74.
[509] 37,500 – 7,894.74 = 29,605.26.
[510] 29,605.26 / 150,000 * 100% = 19.7%.

							imposed by NL)
Tax position in USA	$12,000[511]	$152,000[512]	$28,000[513]	18.4%[514]	$25,789.47[515]	$2,210.53[516] *(i.e., tax due in USA)*	**18.4%**[517] *(i.e., tax burden imposed by USA)*

Yet again the tax burdens imposed by the Netherlands and the United States of America would not alter in the cross-border scenario when compared with the purely domestic scenario. Again the tax burden imposed would not be affected as a consequence of taxpayer Johnson's place of residence or the geographical locations of its sources of income. The Netherlands would maintain to tax taxpayer Johnson at an effective rate of 19.7%. The United States would tax Johnson at a rate of 18.4%. Moreover, both the Netherlands and the United States of America would receive their fair share of the tax pie. Equity and neutrality within the Netherlands and the United States of America would be achieved, even in the case of taxpayers keeping their tax books in a third country currency.

In the *reverse situation* in which the US. Dollar drops in value, referred to in the above as scenario (iii), case f), things would work out in the exact opposite manner. Again the tax burden imposed by the Netherlands and the United States of America is the same in both domestic and cross-border scenarios. Again I did not forward the non-discriminatory and neutral effects by means of a schedule. Also on this occasion, the reader is respectfully challenged to determine these effects himself.

3.5.4 Not all distortions would be resolved…

3.5.4.1 Analysis builds on assumption of absence of disparities

It needs to be repeated that the aforementioned numerical examples are based on the assumption that all nation states involved operate the exact same international tax system. It is assumed accordingly that no disparities exist.

This is obviously untrue in the real world. Disparities between international tax systems can and do exist. This is true even within the European Union's internal market without internal frontiers. All Member States operate their own system and employ a variety of mutually diverging approaches towards the recognition of the taxable entity, the calculation of the taxable base, the applied tax rate and the international tax principles upon which they mutually distribute taxing entitlements.

These disparities or mismatches result in distortions in the functioning of the emerging global marketplace. From the perspective of seeking equity and neutrality in a global market, the presence of disparities in the international tax regime is undesirable. Nevertheless, these distortions will remain in place as long as further international coordination remains absent.

3.5.4.2 Analysis builds on assumption of adequate building blocks of international taxation

Moreover, the examples are also based on the assumption that the cross-border sourcing of business income of branches A and B occurs in a manner corresponding with economic reality. It accordingly builds on the assumption that the building blocks of the international tax regime, which find their origins in the 1920s Compromise, operate adequately – e.g. the permanent establishment threshold and the separate entity approach.

[511] 60,00 – 28,000 – 20,000 = 12,000.
[512] 140,000 + 60,000 – 28,000 – 20,000 = 152,000.
[513] 5,000 + 10,000 + 0,25 * 52,000 = 28,000.
[514] 30,000 / 160,000 * 100% = 18.8%.
[515] 140,000 / (200,000 – 28,000 – 20,000) * 28,000 = 25,789.47.
[516] 28,000 – 25,789.47 = 2,210.53.
[517] 2,210.53 / 12,000 * 100% = 18.4%.

The common building blocks of international taxation however operate in a distortive manner. As elaborated upon in the introduction in section 1.4.3 of Chapter 1, the international tax regime has become outdated and flawed. The concept of separate accounting produces arbitrage in the organizational form (see further Chapter 4), the nominal return to equity tax base standard produces financing discrimination issues (see further Chapter 5) and the separate accounting / arm's length standard fails to properly allocate the tax base geographically (see further Chapter 6).

The consequence of this is that, despite its merits, the advocated system elaborated upon in the above sections would be unable to resolve the occurring market distortions that arise as a consequence of the disparities and the inadequacies in the international tax regime. These distortions would uphold even were the advocated fractional system to be adopted in the real world.

3.5.5 But distortions due to obstacles would be...

3.5.5.1 Discriminations and restrictions internal to the international tax systems of nation states would be eliminated

However, having said this, the hypothesis that the approach as advocated in the above – were it to be actually implemented in each state's international tax system – would render the remaining distortions in the functioning of the international markets to no longer be caused by unilaterally imposed obstacles is not analytically disproved. Accordingly, each single international tax system would in itself operate in an internally equitable and production factor neutral manner. Viz., as seen from their unilateral perspectives, all would impose identical tax burdens on proceeds from both domestic and cross-border economic activities – or intra-European Union to the extent that the Treaty on Functioning of the European Union applies. That is, essentially as European Union law requires the Member States to produce under the application of the fundamental freedoms.

The tax sovereignty of the nation states in the field of direct taxation would be respected. The advocated approach would merely take away the discriminations and restrictions internal to the international tax systems of states. In cases falling within the scope of application of the Treaty on Functioning of the European Union, the European Union fundamental freedoms would be respected to its fullest extent at the same time. That is because the tax burden in the domestic scenario and cross-border scenario would be identical.

Hence, it should be appreciated that the occurring distortions in the operation of the global market subsequent to an introduction of the approach as advocated in the above would no longer be the result of an obstacle unilaterally imposed by a taxing state. Under the advocated approach, this issue would have been resolved. The resulting market distortions would then only be caused by the disparities and inadequacies in the formula as defined in Chapter 1.[518] These distortions may only be removed through harmonization and a rethinking of the concepts commonly applied in international taxation (see the upcoming chapters 4 through 6).

3.5.5.2 Van Raad's 'fractional taxation' and the 'resident taxpayer treatment' of non-'resident taxpayers individuals' in Dutch individual income taxation

Van Raad's 'fractional taxation'

A system that is similar in some ways to the approach advocated in the above has been suggested by Van Raad in the late 1990s and early 2000s with respect to the taxation of

[518] See for a comparison Court of Justice, case C-336/96 (*Gilly*) in which the court considered the distortive effects of applying the second limitation under the ordinary credit method, i.e., no double tax relief for foreign tax levied exceeding an amount equal to the domestic tax that is attributable to the foreign income items, to be a disparity.

individuals with their place of residence within the territories of the European Union. Van Raad refers to it as *"fractional taxation"*.[519] He repeated his arguments in 2010 with a particular focus at the individual income tax treatment of personal allowances and personal expenses.[520] Conceptually, there seems to be no reason not to extend the reach of such a fractional approach and extend its application to the area of corporate taxation.

The opting in for resident taxpayer treatment of non-resident individuals in Dutch individual income taxation

Notably, in 2001 the Dutch tax legislator – on non-discrimination grounds – allowed individuals who are taxed as non-resident taxpayers in the Netherlands to opt for tax treatment as resident taxpayers. The provision is laid down in Article 2.5 of the Dutch Individual Income Tax Act of 2001 (Dutch IITA 2001). The objective of this – to my knowledge rather exceptional – mechanism is to remove the difference in tax treatment between resident and non-resident taxpayers individuals. Non-resident taxpayers who opt for resident taxpayer tax treatment are taxed on their worldwide income. The Dutch-style double tax relief mechanism is subsequently available with respect to these non-resident taxpayer's foreign source income items.

Accordingly, non-resident taxpayers individuals opting-in for the application of resident taxpayer treatment are essentially granted the tax treatment basically advocated in this study. Accordingly the advocated system is already available in the current international tax regime – i.e., albeit in some rudimentary form.

The 'option for resident taxpayer tax treatment' in Dutch individual income taxation is, however, only available to taxpayers/individuals who have their place of residence within a European Union Member State or a state with which the Netherlands has concluded a double taxation convention. Accordingly, the difference in discriminatory income tax treatment of non-resident taxpayers in comparison with resident taxpayers is sought to be resolved by way of an 'opting-in for equal treatment rule'.

Furthermore, no full tax-parity has been achieved. Some differences in treatment have been kept in place initiating non-discrimination issues.[521] In addition, the tax-parity sought entails a divergent approach under domestic law and the double tax convention networks that the Netherlands has concluded. The opting-in regime has the effect that the foreign income of a non-resident taxpayer is included in Dutch tax base (worldwide taxation of non-resident taxpayers) for calculation purposes, even if the foreign income is taxable only in the non-resident taxpayer's residence state abroad (source taxation of non-resident taxpayers). As this system is not in line with the double tax conventions, the domestic opting-in regime has attracted discussions in the Dutch tax literature as to whether it is compatible with the double tax conventions that the Netherlands has concluded; these matters are not further discussed.

Court of Justice in Gielen*: 'no non-discriminatory tax treatment per option'*

Moreover, the mechanism does not apply automatically. Accordingly, the difference in tax treatment still applies in cases where individuals do not opt for equal treatment.

In the *Gielen* case however the Court of Justice held, in my view on fair grounds that the Netherlands cannot justify a discriminatory difference in the tax treatment of non-resident

[519] See Cornelis van Raad, 'Fractional Taxation of Multi-State Income of EU Resident Individuals – A Proposal', in Krister Andersson et al (ed.), *Liber Amicorum Sven-Olof Lodin: Modern Issues in the Law of International Taxation - Series on International Taxation v. 27* (2001) 211, at 211-221. See also Cornelis van Raad, 'Fractionele belastingheffing van EU buitenlandse belastingplichtigen', in J. Verburg et al, *Liberale Gifte (vriendenbundel Ferdinand Grapperhaus)* (1999) 297, at 297-305, and Kees van Raad, 'Non-discriminatory Income Taxation of Non-resident taxpayers by Member States of the European Union: a Proposal', 26 *Brooklyn Journal of International Law* 1481 (2000-2001), at 1481-1492.

[520] See Kees van Raad, 'Non-Residents – Personal Allowances, Deduction of Personal Expenses and Tax Rates',*2 World Tax Journal* 154 (2010), at 154-161.

[521] See Article 2.5 Dutch IITA 2001 as in place until 2015. Note that my interest in this respect is mainly devoted to the mechanism conceptually rather than the distorting manner in which it has been laid down in the current Dutch tax legislation.

taxpayers vis-à-vis resident taxpayers under European Union law by simply referring to the option to elect for non-discriminatory tax treatment under a specific provision in the Dutch IITA 2001.[522] Discriminatory tax treatment is incompatible with the fundamental freedoms and should therefore be abolished from the Dutch tax system: in jure rather than by option.

Worth noting at this place are the steps taken by the Dutch tax legislator in response to the decision rendered by the Court of Justice in the *Gielen* case.[523] The tax legislator could have chosen to apply aforementioned 'option for resident taxpayer tax treatment' in jure, i.e., to all (European Union) taxpayers with income from Dutch sources. Such a response would have removed all unilaterally imposed tax obstacles in the current Dutch direct tax system with the stroke of a pen. However, instead the Dutch tax legislator decided to merely amend the specific discriminatory element that had been under the scrutiny of the Court of Justice in the *Gielen* case – the case involved the 'working hours test' on the basis of which only working hours spent by non-resident taxpayers/individuals within Dutch territories were eligible for being granted a tax incentive, a certain taxable base reduction for self-employed individuals. The discrimination issue arose as the working hours spent abroad by equivalent resident taxpayers were eligible for the tax incentive. The tax legislator responded by including the working hours spent abroad by non-resident taxpayers in the incentive regime.

In my view, by doing so, the tax legislator failed to see that the discriminatory 'working hours test' that was under scrutiny in the *Gielen* case was just a symptom of an underlying illness in the Dutch tax system: the difference in tax treatment of non-resident taxpayers – who are subject to a limited tax liability – in comparison with resident taxpayers – who are subject to an unlimited tax liability. The 'working hours test' was just one of the many features of the underlying discrimination issue. It is just a symptom. If the problem that arose in the *Gielen* case had not been created by the Dutch tax legislator in the first place, i.e., had not created the arbitrary difference between resident and non-resident taxpayers in the first few paragraphs of the Dutch IITA 2001, Mr. Gielen's foreign working hours would have made him eligible for the 'self-employed persons' deduction automatically. Then the discrimination issue would never have occurred in the first place. The effect of the application of Article 2.5 Dutch IITA 2001 shows evidence of this. And a problem that does not arise does not have to be resolved.

To avoid arbitrage, the system as advocated should apply *in jure* rather than per option. European Union law seems to require this as well.[524] At first glance, the fractional approach as advocated in this chapter may be considered somewhat odd; or at least counterintuitive perhaps. The thinking process required, however, seems less substantial than it initially seems perhaps. Viz., the approach is already present within the international tax regime. It is already there; under Article 2.5 of the Dutch IITA 2001. The next step in the thinking process is to look at the approach on an autonomous basis, i.e., taken out of the legal context within which it applies and to introduce it in the international corporate tax system of any nation state.

Resident taxpayer treatment of 'qualifying' non-resident individuals in Dutch individual income taxation as of 1 January 2015

The notion of automatic application of the system may not be considered as far-fetched as perhaps initially thought. In fact, as of 1 January 2015 the Dutch opting-in regime will be replaced by a mandatory regime. Per 2015 the so-called 'qualifying' non-resident taxpayers individuals will be treated as resident taxpayers/individuals for tax purposes.

Although no full tax-parity has been achieved and non-discrimination issues are initiated once again, albeit this time vis-à-vis both resident taxpayers and non-qualifying non-resident taxpayers. Furthermore, the pool of eligible non-resident taxpayers is reduced in scope vis-à-vis the current opting-in regime. Only residents of the Caribbean part of the Netherlands,

[522] See Court of Justice, case C-440/08 (*Gielen*).
[523] See the Decree by the State Secretary for Finance of 10 June 2010, no. DGB2010/2574M, *Vakstudie-Nieuws* 2010/28.18.
[524] See Court of Justice, case C-527/06 (*Renneberg*). See also Court of Justice, case C-440/08 (*Gielen*).

residents of a European Union Member State, and residents of a European Free Trade Association Member State are eligible. Furthermore, these Dutch non-resident taxpayers must derive at least 90% of their income from Dutch sources.[525] That hardly may be seen as a step in the right direction, but still. At least the system applies automatically.

3.5.5.3 Tax-parity of residents and non-residents is attainable: it is also done in value added taxation

It is by no means impossible to treat residents and non-residents on par for tax purposes. It has been done in value added taxation ('VAT'), i.e., at least within the context of the European Union. The VAT system in the European Union, for instance, does not distinguish between resident and non-resident taxpayers at all.

Under the European Union-style VAT, the taxpayer is 'any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity'.[526] Actual VAT becomes due within a certain European Union Member State subsequently when goods or services are supplied within the territory of that European Union Member State. Liability to VAT arises upon establishing nexus with the territories of the taxing state.

As this European consumption tax does not distinguish between taxpayers on the basis of their place of residence, no discrimination issues arise as a consequence of that. Accordingly, the VAT lacks the discrimination issues as often recognized in direct taxation. This is no coincidence.

3.5.5.4 Advocated system in treaty scenarios; administrative assistance called for

The tax system advocated could be implemented by a particular nation state and apply *in jure* in scenarios falling within the scope of application of a nation state's double tax convention network, or within the confines of the Treaty on Functioning of the European Union – the latter regarding intra-European Union investment. In such cases, the approach advocated could apply on the basis of the reciprocity principle.

Various administrative tools supporting the advocated system would need to be implemented for it to function properly. Taxpayers, for instance, would have to provide information on their cross-border business activities. Intensive mutual administrative assistance and cooperation between states would be required. Legal remedies such as international arbitration procedures would need to be introduced. The presence of accompanying administrative mechanisms would be of significant importance. These provisions would need to be made available in the respective states' international tax systems. One may think of the administrative provisions in domestic legislations and double tax conventions networks involved, as well as the Mutual Assistance Directive and Arbitration Convention in a European Union context.

Indeed, this may lead to administrative difficulties. However, these practical challenges would not necessarily be insurmountable. At the end of the day, the political willingness of nation states to assist each other administratively that is required may prove to be the bottleneck for a proper functioning of the approach advocated above. In the event that a system in line with advocated approach would give rise to practical problems in assessing the corporate tax – e.g. if practice would show that the relevant information for the determination of the taxpayer's tax position has not been provided– the solution to that problem would have to be found in the improvement of international administrative assistance. Worth noting is that it may be recognized that a globalizing marketplace in the end just calls for cross-border administrative

[525] The tax legislator has found its inspiration for the 90% threshold in Court of Justice, case C-279/93 (*Schumacker*). Other rulings of the court however imply lower or at least dissimilar thresholds, see for instance Court of Justice, cases C-39/10 (*Commission/Estonia*) and C-182/06 (*Lakebrink*). It accordingly remains to be seen whether European Union law allows The Netherlands in the end to uphold the 90% income requirement as a threshold for tax-parity of non-resident taxpayers with resident taxpayers.

[526] See Article 9, first indent, Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

assistance mechanisms in corporate taxation. The recent developments in 'country-by-country reporting' – which would require multinationals to make a per-country break-down of their profits– show evidence of a trend towards an international consensus on the need for global transparency in tax administrative matters.[527]

The potential for issues of an administrative nature would not render the advocated approach analytically invalid. Worth noting by means of an illustration is that the Court of Justice does not consider administrative difficulties such as a lack of information on the foreign income of taxpayers a ground to justify obstacles imposed by European Union Member States regarding intra-European Union economic activity.[528] In these cases the court consistently rejects this argument by pointing out that relevant information can be obtained on the basis of the Mutual Assistance Directive, for instance.

3.5.5.5 Switch-over to credit mechanism to counter potential for tax-abuse

The potential shelter of passive income in a foreign low-tax jurisdiction[529] that is perhaps available under the advocated approach may be countered by making use of a switch-over mechanism. To tackle the potential of tax abuse beforehand, the relief system could switch-over the commonly applied ordinary credit for foreign tax method instead of the advocated Dutch-style double tax relief mechanism in those cases. Such a switch-over could accordingly be based on anti-tax abuse considerations.[530]

The switch-over could be made available in cases where neither a double tax convention nor the Treaty on Functioning of the European Union applies. The switch-over could apply on the basis of a motive test. Inspiration for the design of such a motive test can be found in the case law of the Court of Justice's as developed in its Cadbury Schweppes and Part Service rulings.[531] In that event, the switch-over to the direct credit mechanism would apply to artificial arrangements that lack economic substance and that have been set up with the intention of escaping any domestic corporate tax normally payable.[532] The switch-over could be combined with a 'subject to a reasonable tax clause'.[533] If the taxpayer demonstrates that its passive income abroad is subject to a reasonable tax, the switch-over would not kick in. That is because in such a case the motive of dodging corporation tax liabilities may be deemed to be absent.

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[527] See, e.g., the work undertaken by the OECD in this area, notably, OECD, OECD Committee on Fiscal Affairs, *Memorandum on transfer pricing documentation and country-by-country reporting*, OECD Publishing, Paris, 3 October 2013, OECD, OECD Committee on Fiscal Affairs, *Public Consultation; Discussion draft on Transfer pricing Documentation and CbC Reporting*, OECD Publishing, Paris, 30 January 2014, and OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*, OECD Publishing, Paris, 16 September 2014.

[528] See e.g. Court of Justice, cases C-101/05 (*Swedish A*), C-446/04 (*FII*), the joined cases C-437/08 C-436/08 (Haribo & Salinen), and case C‑72/09 (*Rimbaud*).

[529] Tax sheltering incentives may perhaps arise since the relief provided for under the advocated system is calculated by reference to domestic standards rather than the tax burden at the other side of the tax burden.

[530] Cf. Court of Justice, case C-196/04 (*Cadbury Schweppes*). Contra Court of Justice, case C-403/03 (*Egon Schempp*). Contrary to B.J.M Terra et al, *European Tax Law* (2012), at 64, and the Court of Justice in the Egon Schempp case, the position taken in this study is that market distortions that result from the application of subject to tax clauses analytically cannot qualify as a disparity. These distortions are caused by obstacles that need to be justified. The subject to tax clause in the German tax regime re outbound alimony payments seeks to ensure that alimony payments in Germany are tax-deductible only if these payments are taxed in the hands of the recipient at the other side of the tax-border. In other words, the subject to tax clause seeks to counter less than single taxation resulting from the differences between the European Union Member States' tax systems re alimony payments – a disparity accordingly, i.e. the tax-deduction (payer) and taxation (recipient) of alimony payments in Germany and the non-taxation and non-deduction of equivalent payments in the foreign taxing jurisdiction involved. Germany seeks to correct the disparity involved by unilaterally imposing an obstacle, i.e., the subject to tax requirement. In my view, such an obstacle may be justifiable on the basis of anti-tax abuse considerations.

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

[532] See on anti-abuse rules generally, and particularly in respect of the anti-abuse clause in the European Commission's CCCTB proposal, Peter Harris, 'The CCCTB GAAR: A Toothless Tiger or Russian Roulette?', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012), at 271-297.

[533] See for a comparison Vogel's remarks on introducing a subject to tax clause as an anti-abuse measure in Klaus Vogel, 'Which Method Should the European Community Adopt for the Avoidance of Double Taxation?', 56 *Bulletin for International Taxation* 4 (2002), at 6.

Taking the principle of administrative convenience into account, the switch-over mechanism may for example be combined with a rule that places the burden of proof, i.e., the burden of providing conclusive evidence in support of the position that no tax sheltering is engaged in, at the level of the taxpayer invoking double tax relief. Notably, this would require some international consensus on what constitutes a reasonable tax. One may for instance internationally agree on effective average tax rate bandwidths (see for some analytical comparison Chapter 6 at section 4.6.

The merits of introducing a switch-over mechanism to tackle the potential for abuse under the approach as advocated up until this point of the current analysis, is not further discussed as this study ultimately advocates a destination basis profit allocation mechanism. That would resolve the tax sheltering issue conceptually through alternative means.

3.6 The Court of Justice's alternative, pragmatic, route to Rome: the territoriality principle

3.6.1 The Court of Justice seeks equilibrium between Member State tax sovereignty and the fundamental freedoms

3.6.1.1 Pragmatically balancing tax sovereignty and the free movement rights; the territoriality principle to justify an obstacle imposed

Balancing tax sovereignty and the free movement rights

In its case law on the fundamental freedoms in the field of direct taxation, the Court of Justice of the European Union tries to unify the internal market without internal frontiers and the current European Union Member States' sovereignty in direct tax matters. As referred to in the above, the fiscal sovereignty of the European Union Member States cannot conceptually coincide with the concept of the internal market without internal frontiers. Yet, the sovereignty of the Member States in the field of direct taxation is a given as long as their sovereign powers in this field are not transferred to the European Union.

In balancing the internal market and the sovereign competences of the European Union Member States in direct tax matters, the Court of Justice has developed the so-called territoriality principle.[534] Under its 'rule of reason' the Court of Justice currently regards territoriality as a ground to justify an obstacle imposed by a Member State. The territoriality principle basically entails that European Union Member States are allowed to effectively keep foreign source income items out of their domestic tax base and to ensure that domestic income is actually being taxed.[535] The Court of Justice accordingly recognizes the sovereignty of European Union Member States in direct tax matters by recognizing the territoriality principle.

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[534] Cf. Frans Vanistendael, 'In Defense of the European Court of Justice', 62 *Bulletin for International Taxation* 90 (2008), at section 3. Contra Dennis M. Weber, 'Vpb 2007. Een stelsel gebaseerd op het territorialiteitsbeginsel: EG aspecten en contouren', 133 *Weekblad Fiscaal Recht* 1297 (2004), at section 3.2.2. For some details on the territoriality principle, see B.J.M Terra et al, *European Tax Law* (2012), at 69-70, and 455-458. For an extensive analysis of the 'territoriality principle' in EU law, see Otto Marres, 'The Principle of Territoriality and Cross-Border Loss Compensation', 39 *Intertax* 112 (2011, No. 3), at 112-125.

[535] The Court of Justice has put this into words in case C-414/06 (*Lidl*) as the *"need to preserve the allocation of the power to impose taxes between the EU Member States concerned (…) and to prevent the danger that losses may be taken into account twice"*. In addition to this the Court of Justice referred to a ground for justification founded on anti-tax abuse considerations, i.e. the *"risk of tax avoidance"* in case C-446/03 (*Marks & Spencer II*). Cf. Court of Justice, cases C-231/05 (*Oy AA*) and C-157/07 (*Krankenheim*). Other grounds for justification are the need to guarantee the effectiveness of fiscal supervision in situations falling outside the scope of application of the Mutual Assistance Directive (see Court of Justice, cases C-101/05 (*Swedish A*) and C-446/04 (*FII*)) and anti-tax abuse considerations in situations where wholly artificial arrangements are set up with the purposes of *"circumventing the application of the legislation of the Member State concerned"* (see Court of Justice, cases C-196/04 (*Cadbury Schweppes*) and C-425/06 (*Part Service*); see also Opinion of A-G Mengozzi in Court of Justice, case C-298/05 (*Columbus*)).

However, the rationale of the internal market without internal frontiers dictates that European Union Member States expressing the territoriality principle in their international tax systems should do so in a manner that least distorts the functioning of the internal market – the 'proportionality test'. The expression of the territoriality principle in Member State's international tax system needs to be both effective and economically efficient – i.e., the tax measure involved needs to be suitable to achieve the objective of keeping foreign/domestic income outside/inside the domestic tax base and to not go beyond what is necessary to obtain that objective.[536]

At the end of the day this means that European Union Member States are required to arrange their tax systems in a manner which ensures that taxpayers can cross the tax borders without being hindered by unilateral tax measures. In other words, the European Union Member States are required to unilaterally enable a change of tax jurisdictions by economic operators and its economic operations in an internally equitable ('market equality principle') and internally neutral ('market neutrality principle') manner.

Balancing pragmatically, as justified obstacles conceptually cannot exist since an obstacle-free system is feasible

The Court of Justice pragmatically brings together the internal market without internal frontiers and the European Union Member States' sovereignty in the field of direct taxation. The Court of Justice's approach is pragmatic; under the Court's decision scheme no obstacle justified by the territoriality principle can exist conceptually. Viz., as soon a Member State's tax border is actually crossed in an equitable and tax-neutral fashion, i.e., compliance with the requirement under the proportionality test, there is no obstacle.

From the perspective of the international tax system of the individual Member State, the fundamental movements essentially require an intra-European Union business activity to receive the exact same tax treatment as a non-intra- European Union business activity in terms of the tax burdens imposed. As it is possible to develop an approach that allows a completely neutral and non-discriminatory border crossing of taxpayers and their sources of income it is equally possible to remove obstacles all together. Obstacles would be gone if a country were to adopt the obstacle-free international tax system as advocated in the above.

Accordingly, each apparent justification under the territoriality principle of an obstacle imposed in the international tax system of a particular European Union Member State proves that tax measure at hand disproportional, and with that incompatible with the fundamental freedoms. That is because an obstacle-free alternative is available. The approach advocated in the above would enable the single taxation of domestic income in both an effective and an efficient way. Accordingly, each international tax system that conceptually moves away from the approach advocated in the above implies the presence of an obstacle that cannot be justified as an equitable and neutral alternative is available. The remaining distortions within the internal market would then only be caused by a disparity or the inadequate building blocks of international taxation.

3.6.1.2 Doing the math would lead to the same point of destination as the approach advocated in this study

It follows that the interpretation of the fundamental freedoms necessarily promotes the same system as the notions of internal equity and production factor neutrality. That is, the worldwide taxation by a taxing jurisdiction of economic operators having domestic nexus whereby double tax relief is granted regarding foreign nexus under the 'credit for domestic tax attributable to foreign income'. The maths reveal that the tax burdens on the domestic and cross-border investment proceeds of resident taxpayers and non-resident taxpayers under

[536] See also Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010), as well as Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55.

such a system are identical in all countries where the taxpayer involved has nexus. Since there are no tax burden differentials there are no obstacles.

Accordingly, only this taxing methodology truly promotes the equal tax treatment of resident taxpayers and non-resident taxpayers. And only this taxing methodology truly promotes the economic efficient tax treatment regarding their inward bound and outward bound investments. In sum, also the fundamental freedoms conceptually necessarily arrive at the same destination at the end of the road as the approach advocated in the above sections of this study.

3.6.2 The Court of Justice's pragmatic interpretations have however produced ambiguities

3.6.2.1 The Court of Justice's reasoning has been ambivalent

However, as the Court of Justice's case law currently stands, the Court unfortunately takes an ambivalent approach when it comes to the interpretation of its rule of reason – particularly its interpretation of the territoriality justification ground.[537] A review of its case law reveals that it is unclear whether or not the Court of Justice allows the Member States some leeway to uphold unilaterally imposed obstacles when expressing the territoriality principle in their international tax systems.

3.6.2.2 'Territoriality effectively achieved suffices'

An affirmative answer to this question can be derived from the observations of the Court of Justice in the *Futura*, *Marks & Spencer II*, *Lidl*, *X Holding*, *A Oy* and *K.* cases.[538] In these cases the Court of Justice allows the Member States involved to treat the proceeds from cross-border business activities and proceeds from domestic economic activities differently for corporate tax purposes.

X Holding, *Marks & Spencer II*, and *A Oy* deal with the effects of the failure to grant taxpayers an offset of their foreign source losses against their domestic source profits, i.e., under a 'base exemption' for foreign source income derived from intra-European Union business activities of groups of affiliated companies. *Futura*, *Lidl*, *A Oy*, and *K.* also deal with the effects of not granting taxpayers an offset of foreign source losses against domestic source profits, i.e., a base exemption for foreign source income derived from intra-European Union business activities of single corporate taxpayers.

In all cases the Court of Justice shows evidence that it does not have a problem – at least not to some extent – with the liquidity or other disadvantages that the Member States unilaterally created in their tax systems regarding the tax treatment of foreign source losses vis-à-vis the tax treatment of domestic source losses. Notably, the same holds true with regards to the levy of exit taxes on outward bound intra-firm supplies of goods, capital asset transfers or services rendered. In *National Grid Indus* the Court of Justice effectively allowed the Member State involved to impose such an exit tax upon the transfer of assets abroad – i.e., even though the Member State involved did not levy such a tax on equivalent transfers within its territories.[539]

In these cases the Court of Justice approved unilaterally imposed obstacles – i.e., the liquidity or other disadvantages that result from the application of an import neutrality promoting

[537] See further, Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010). See also Dennis M. Weber, 'Refusal of advantages of a cross-border tax consolidation in some situations an unjustified restriction of the freedom of establishment', *Highlights and Insights on European Taxation* 2010/1.6. Contra, Tom O'Shea, 'European Tax Controversies: A British-Dutch Debate: Back To Basics and Is the ECJ Consistent?', 5 World Tax Journal 100 (2013), at 100-127, who argues that the Court of Justice is extremely consistent and that much of the criticism of its case law in the scholarly literature is wrong.
[538] See respectively Court of Justice, cases C-250/95 (*Futura*), C-446/03 (*Marks & Spencer II*), C-414/06 (*Lidl*), C-337/08 (*X Holding*), C-123/11 (*A Oy*) and C-322/11 (*K.*).
[539] See Court of Justice, case C-371/10 (*National Grid Indus*).

territorial tax system by the European Union Member States involved.[540] The European Union Member States apparently may to some extent unilaterally distort outbound investment accordingly. As demonstrated in section 3.2.3.2, these obstacles occur where horizontal loss compensation is not allowed for intra-European Union cross-border business activities, while such a loss-compensation is made available for intra-European Union domestic business activities. In such an event taxpayers with business activities abroad can only rely on local vertical loss set-off possibilities, if available – i.e., the compensation of losses realized in another tax year. This results in liquidity or other disadvantages in respect of outbound investment. [541] The Court of Justice apparently has no problem with that in these cases.

It may be inferred from these court rulings that the European Union Member States have a certain margin of appreciation in deciding on the manner in which they keep their taxpayers' foreign income items outside their domestic tax bases. Apparently, the European Union Member States are 'more or less' entitled to maintain certain unilaterally imposed obstacles. It may be argued that the Court of Justice embarked upon a slippery slope by allowing for such a margin of appreciation, and encroaches upon the objective of attaining an area without internal frontiers within which economic operators and their economic activities can move unimpaired. In the end, the Court's case law does not promote equity and neutrality.

Under this case law the court accordingly seems to have created a gap between the freedoms as to how they ought to apply and the manner in which the court has interpreted them. A difference between 'is' and 'ought' accordingly.

3.6.2.3 Territoriality effectively achieved is insufficient; it should be achieved efficiently

A negative answer to the question as to whether the Member States' have some leeway to uphold the obstacles in their tax systems can be derived from the Court of Justice's case law. That is, particularly in its observations in the cases *Renneberg*, *Metallgesellschaft/Hoechst* and *FII 1*.[542] Contrary to *Futura*, *Marks & Spencer II*, *Lidl*, *X Holding*, *A Oy* and *K*,[543] these cases do not demonstrate a permissible margin of appreciation available to European Union Member States seeking to effectuate the territoriality principle in their international tax systems. In these cases the Court of Justice – in my view fairly – considered the unilaterally imposed liquidity disadvantages incompatible with the fundamental freedoms.[544]

Moreover and more fundamentally, in *Renneberg* the Court of Justice – in my view fairly – ruled that the difference in tax treatment of non-resident taxpayers vis-à-vis resident taxpayers was discriminatory. As said, the non-resident taxpayers' foreign income is typically effectively base exempt under the application of a territorial system, while the resident taxpayer's foreign income is typically included in the taxable base. Subsequently double tax relief is provided. The case at hand, as explained, involved the Dutch-style tax exemption mechanism that the Netherlands did not make available to the non-resident taxpayer involved. Notably, a similar approach of the Court of Justice may be derived from the *N.* and *Lasteyrie* cases. In these cases the Court of Justice considers the levy of exit taxes payable in the event of outward bound movements of equity capital – i.e., an expression of a territorial tax system – incompatible with the fundamental freedoms.[545] Indeed, the observations of the court in *N.* and *Lasteyrie* are analytically opposite to those in *National Grid Indus*.

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[540] See for some analyses of the distorting effects to outbound investment of territorial systems, Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55.

[541] For an extensive elaboration of this argument see Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55.

[542] See respectively Court of Justice, cases C-527/06 (*Renneberg*), C-410/98 (*Metallgesellschaft / Hoechst*) and C-446/04 (*FII 1*).

[543] See respectively Court of Justice, cases C-446/03 (*Marks & Spencer II*), C-414/06 (*Lidl*), C-337/08 (*X Holding*), C-123/11 (*A Oy*) and C-322/11 (*K.*). Cf., Court of Justice, cases C-231/05 (*Oy AA*) and case C-157/07 (*Krankenheim*).

[544] Contra Opinion of Advocate General Sharpston in Court of Justice, case C-414/06 (*Lidl*). I think that unilaterally imposed liquidity disadvantages may only be justified on the basis of anti-tax abuse considerations. Cf. Court of Justice, case C-196/04 (*Cadbury Schweppes*).

[545] See Court of Justice, cases C-9/02 (*De Lasteyrie du Saillant*) and C-470/04 (*N.*).

In these cases the Court of Justice disapproved unilaterally imposed obstacles – i.e., the liquidity or other disadvantages that result from the application of an import neutrality promoting territorial tax system, as the court ruled that the Member States involved in these cases infringed on the free movement rights. According to these court rulings the Member States apparently may not unilaterally distort outbound investment. This case law shows that the Court of Justice has a problem with the Member States maintaining liquidity or other disadvantages in their territorial tax systems.

3.6.2.4 Dislocations thus sometimes upheld and sometimes struck down

In consequence, the Court of Justice adopted a somewhat ambivalent approach when it came to the justification of an obstacle imposed on the basis of the territoriality argument. Sometimes the Court upholds the dislocations (*Futura*, *Marks & Spencer II*, *Lidl*, *X Holding*, *A Oy*, *K, National Grid Indus*), and sometimes it dismisses them as discriminatory (*Renneberg*) or restrictive (*Lasteyrie*, *N.*).

Indeed, by basically acknowledging the base exemption as a proportional expression of the territoriality principle in *Futura*, *Marks & Spencer II*, *Lidl*, *X Holding*, *A Oy*, *K, National Grid Indus*, yet refuting it in *Renneberg*, *Lasteyrie*, and *N.,* the Court of Justice seems to have taken a somewhat arbitrary course. That is, with respect to the question whether the fundamental freedoms require the European Union Member States to make sure that taxpayers who change tax jurisdictions are treated equitably and neutrally for tax purposes.

3.6.3 Legal uncertainty is the Court of Justice's case law's product

3.6.3.1 Lack of clarity in how the Court of Justice's rulings mutually relate

This analytically inconsistent body of case law has left it somewhat unclear how the observations of the Court of Justice in the aforementioned cases relate to each other. Although the rulings of the Court of Justice should be consistent in theory, in practice they are not, i.e., at least so it seems. Theoretically, the body of case law should be internally consistent as requests for a preliminary ruling of the Court of Justice on the interpretation of the free movements is analytically the same, time and again. 'Is there an obstacle?' In practice the Court of Justice's case law may even provide sufficient grounds for diverging, perhaps even random, conclusions.

In addition, the inconsistencies in the Court of Justice's case law create legal uncertainty. Illustrative are the opposite Opinions of the Dutch Advocate General Wattel that he delivered within a period of less than a year on the compatibility or incompatibility of the Dutch tax consolidation regime with the freedom of establishment on which the Court of Justice later ruled in *X Holding* (see chapter 4 for some analysis). In July 2007, the Advocate General had some serious doubts as to the compatibility of the regime with the freedoms.[546] However, in September 2008, he considered the regime compatible with the freedoms due to some later developments in the Court of Justice's case law.[547]

This is unfortunate. Taxpayers crossing the tax border deserve to be treated internally equitable and neutral for tax purposes. And to have legally certainty as well.

[546] See the Opinion of Advocate General Wattel, 4 July 2007, *Vakstudie-Nieuws* 2007/47.16.
[547] See the Opinion of Advocate-General Wattel, 11 September 2008, *Vakstudie-Nieuws* 2008/47.14. See for a comparison the Opinion of Advocate-General Kokott, 19 November 2009, Court of Justice, case C-337/08 (*X Holding*) in which Kokott opined that the Dutch tax consolidation regime may generally be regarded as being compatible with the freedom of establishment.

3.6.3.2 Relying on the Court of Justice's observations or taking an autonomous course?

The following may be inferred from the above as well. The Court of Justice does not seem to provide a sufficient guideline to identify an unambiguous normative framework for the purpose of answering the question of when European Union Member States impose an obstacle.

The inconsistencies in the court's reasoning have therefore made it analytically necessary in this study to bypass its body of case law and proceed to finding such a normative framework autonomously. For this purpose the analysis relies on international tax theory and the underlying objective of pursuing an internal market without internal frontiers, rather than the Court of Justice's interpretation. The analysis has subsequently been taken outside the legal context of the internal market and has been put into the perspective of an emerging global market. This exercise produced the notions of internal equity and internal neutrality and their effects as a logical corollary. The equitable and neutral effects of the advocated approach boiled down from this exercise have been extensively demonstrated by reference to the tax-effects regarding taxpayer Johnson's dinghy selling operations. The maths simply do not lie.

3.7 Final remarks

This chapter addresses the question of how to the obstacles in the current international tax systems of states should be removed. The chapter accepts that the fiscal sovereignty in corporate taxation lies at the nation state level – i.e., as currently is the case in reality.

Inspired by the approaches found in international tax theory and European Union law in direct taxation, the argument is made that a nation state's international tax system should be internally fair – a notion of 'tax fairness within the international tax system of a state'. Equal circumstances should be treated equally under the operation of the international tax system of the nation state involved. This produces a notion that has been referred to in this chapter as 'internal equity' and 'internal production factor neutrality'.

It has been demonstrated that the international adherence to the widely known tax policy notions of capital and labor import neutrality and capital and labor export neutrality actually do not promote a neutral tax treatment. Import neutrality promoting tax systems distort production factor exports. Export neutrality promoting tax systems distort production factor imports. The same holds true for the double tax relief systems commonly used in international taxation. Alternatively, a concept has been developed that is referred to as 'production factor neutrality'. This concept promotes neutrality in taxation of both inbound and outbound movements of the production factors of capital, labor and enterprise.

The point made is that 'internal equity' and 'internal production factor neutrality' call for a worldwide taxation of business proceeds of firms that have nexus in a taxing state. Under this approach it is irrelevant where a taxpayer has its place of residence or its place of incorporation. It fully operates in a non-discriminatory fashion.

To acknowledge the single tax principle, unlimited tax liability should be combined with an equitable and neutral double tax relief mechanism. For that purpose, reference is made to a double tax relief mechanism referred to as the 'credit for domestic tax attributable to foreign income'. The approach advocated accordingly produces a system in which all countries involved tax their share or fraction of the worldwide income derived by the taxpayer, in other words: 'Taxing the fraction'. In terms of tax burdens it is irrelevant under this approach whether the taxpayer involved operates its business activities in a cross-border or purely domestic environment; the same holds true for the direction of the investment. It accordingly operates in a non-distortive fashion.

The equitable and non-distortive operation of the advocated fractional approach has been illustrated by means of numerical examples, respectively dealing with progressive tax rates, cross-border losses, intra-firm modes of transfers and currency exchange rate fluctuations. To illustrate all this, the assessment engages into a thought experiment in which identical tax

systems apply at both sides of the tax borders. That is to exclude the effects of disparities in the system from the analysis. The approach taken at this point conceptually equals the 'internal consistency test' in US constitutional law.

It has further been argued that a consistent interpretation of the fundamental freedoms under the application of European Union law in the field of direct taxation would necessarily arrive at the same system. That is because the advocated system is comprehensively non-discriminatory and non-restrictive from a European Union law perspective. Unfortunately, in its interpretations of these freedoms, the Court of Justice, however, resorts to ambiguous reasoning in its case law and arrives at analytically inconsistent approaches.

Indeed, the approach advocated in this chapter does not remove any distortions that may arise as a consequence of divergences between the tax systems of the nation states involved – i.e., the disparities and mismatches in the international tax regime. These however render the analysis in the current chapter not invalid. The approach advocated in this chapter merely constitutes a building block towards a fair international tax regime.

The remaining disparities in the current discoordinated international tax regime may be resolved through adequately approximating the international tax systems of the nation states. The questions as to the approaches to be taken to adequately coordinate the international tax regime into a corporate tax 2.0 are addressed in part IV of this study, i.e., the upcoming chapters 4, 5, and 6. These respectively seek to discover the pieces of the international tax jigsaw puzzle involving the definitions of the tax entity and the taxable base and the methodology to be employed to geographically divide that tax entity's taxable base.

Part IV – Towards a fair international tax regime; eliminating disparities adequately

– Chapter 4 –

The group as a taxable entity

Chapter 4 The group as a taxable entity

4.1 Introduction[548]

Building on findings in previous chapters

Chapter 2 of this study concludes with the observation that the notion of fairness in the international tax regime ultimately calls for a worldwide coordination of the international corporate tax systems of nation states. Fairness calls for an approximation of tax systems into an adequately operating coherent international tax regime. However, tax coordination necessarily involves the acceptance of an erosion of the nation state competences to design their corporate tax systems autonomously.

Chapter 3 concludes with the observation that the notion of fairness within the international tax system of a single nation state calls for the appreciation of the concepts of internal equity and internal neutrality, i.e., in the event that the concept of tax sovereignty were taken as an analytical presupposition. The concept of fairness within an international tax system of a state boils down to the worldwide taxation of economic operators having domestic nexus whereby double tax relief is granted regarding foreign nexus under the 'credit for domestic tax attributable to foreign income'. The math has shown that under such a system, the tax burdens of domestic and cross-border investment proceeds of corporate taxpayers would be identical in all countries where the taxpayer involved has nexus. The absence of differentials proves the absence of obstacles under the advocated system.

This chapter builds on the assumption that nation states would be politically willing to mutually coordinate their international tax systems. It is devoted to answering the question of who to tax in an alternative international corporate tax regime. What may be considered the appropriate taxable entity or 'tax subject' in a corporate tax 2.0? Who should be considered the corporate taxpayer to resolve taxable entity mismatch issues?

Tax-treating multinationals as a single entity…

The analysis in the current chapter is inspired by Coase's 'theory of the firm'.[549] It further builds on the notion that equity requires nation states to subject a group of affiliated corporate entities, which jointly operate a business enterprise to an overall tax burden that is equal to the tax burden to which a single corporate entity operating a business enterprise is subject. This notion has been addressed in Chapter 2 and is commonly referred to in the literature as the unitary business approach.[550]

The argument is made that to resolve the arbitrage in the system, nation states should subject the integrated firm as a single entity to corporation tax rather than its constituent individual corporate bodies as separate taxable entities. The separate entity approach should be let go. The international tax regime should abolish the classical system of corporate taxation in which each (affiliated) corporate body forms a separate taxable entity, and where permanent establishments are hypothesized as distinct and separate enterprises for profit attribution purposes. That approach needs to be abandoned and replaced with the unitary business approach. The multinational should be treated as a single taxable entity for corporate tax

[548] This chapter draws from and further builds on Maarten F. de Wilde, 'A Step towards a Fair Corporate Taxation of Groups in the Emerging Global Market', 39 *Intertax* 62 (2011).

[549] Originally stated by Coase in Ronald H. Coase, 'The Nature of the Firm', 4 *Economica* 386 (1937), at 386-405. See also Jean-Francois M. A. Hennart, 'Theories of the Multinational Enterprise', in Alan M. Rugman (Ed.), *Oxford Handbook of International Business* (2009), at 125-145, Richard J. Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World', 2 *World Tax Journal* 291 (2010), at 293-294, Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 826. See also Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286, Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', 62 *Bulletin for International Taxation* 201 (2008), at 201-215, and Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 103-111.

[550] See Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 826.

purposes. This may technically be achieved by means of mandatory tax consolidation. That would enable a matching of the taxable entity and economic entity, i.e., the multinational group. The ultimate parent company could be assigned as the (principal) taxpayer for tax assessment purposes.

From there, a framework is created to identify the taxable entity for corporation tax purposes. The objective is to identify the economic entity that would constitute the taxable entity. To identify the taxable entity, the argument is made that tax consolidation should occur with respect to: (a) corporate interests that provide the ultimate parent company a decisive influence over the underlying business affairs of its subsidiaries, provided that (b) the parent company holds its corporate interest as a capital asset. In addition, tax consolidation should be mandatory in both domestic and cross-border scenarios. That is, a 'worldwide tax consolidation'. The concept is akin to the concept of worldwide 'unitary combination' or 'combined reporting' known in US state income taxation.

Following the building blocks of an international tax system that is internally equitable and production factor neutral, developed in Chapter 3, it is argued that the firm should be subject to an unlimited corporate tax liability in each tax jurisdiction in which it exceeds a minimum threshold of economic activity, i.e., where it has nexus. In cross-border scenarios, double tax relief would subsequently be provided regarding the firm's foreign nexus by reference to the credit for domestic tax attributable to foreign income, i.e., the approach as developed and advocated in the previous chapter.

would enhance fairness…

Such an approach would enhance fairness in the corporate taxation of multinationals. It would bring the corporate tax treatment of corporate groups and single corporate entities on par in both domestic and cross-border scenarios. The coordination of the taxable entity would further promote the neutrality of the legal form. Corporate tax burden and revenue levels would not be influenced by the multinationals' legal structuring or the question of whether business is conducted in a domestic or cross-border context. To that extent, spill-over effects would be eliminated. Such an approach would further cancel out all unilaterally imposed distortions in the taxation of multinationals under the nation states international tax systems. The system would accordingly remain obstacle-free.

but only as a next step…

However, such an approach would only provide an answer to the distortive allocation of corporate tax among corporate taxpayers and between states in a global marketplace; that is, it would not resolve the other distortive properties of the current international tax regime.

Indeed, the legal structuring of the multinational's business activities would cease to influence the territorial allocation of the taxable base. It would however not provide a solution for the issues in the definition of the tax base or its geographic division.[551] It would not resolve the arbitrage in the tax treatment of third-party debt and equity financing. The common nominal return to equity standard would still tax-favor debt over equity financing. It would also not resolve the arbitrage in the concepts utilized to establish corporate tax jurisdiction. Nexus would still be established by reference to the fairly criticized concepts of 'place of effective management' and 'permanent establishment'. It would remain problematic to adequately tax the business proceeds from inbound investments by third party shareholders, creditors, and lessors in the source state. The same would hold for the flaws in the current profit allocation methodologies. The system would still attribute tax base by reference to the fairly criticized concepts of separate accounting and the arm's length standard.

[551] See e.g., Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), Ruud A. de Mooij et al, 'An applied analysis of ACE and CBIT reforms in the EU', 18 *International Tax and Public Finance* 93 (2011), at 93-120, Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010, Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 De Economist 417 (2007), at 417-448, as well as Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08.

However, the definition of the taxable entity by reference to the economic entity may provide the first piece of the international tax jigsaw puzzle. Perhaps resolution of the distortions under the utilization of the separate entity approach via the adoption of the unitary business approach renders this first piece of the puzzle to have fallen into place. This paves the way for discovering the place of the remaining two pieces in Chapters 5 (tax base identification) and 6 (tax base allocation mechanism).

4.2 The multinational firm: a rents producing single economic entity

4.2.1 Multinational firms economically exist as single entities

As it has already been set forth in Chapter 2 multinational firms may be considered to exist in the real world as economic entities separate from their owners.[552] Firms may be considered real as they are homogenous units created economically to maximize profit production for the benefit of its portfolio shareholders. Accordingly, they exist as economic 'joint ventures' or 'partnerships' of the firms' owners who have 'outsourced' the management of their venture to the firm's management.

The presence of a firm's corporate management entails that a firm actually exists as a business venture economically separate from its shareholders. The firm accordingly can be seen as a separate economic operator – an agent with a governance structure.[553] This makes it a homogenous value creator – i.e., more than a mere conduit of the income that is derived by its portfolio investors.[554] As a single economic unit the firm is represented by its corporate management that carries on the business enterprise through its direct investments. If the firm operates its business activities in more than a single country, it is typically labeled as a multinational.

A firm may comprise of a single legal entity or a group of economically integrated legal entities under the common control of an ultimate parent company. Such a decision to legally incorporate the various business operations into separate legal entities may be based on the desire to limit the firm's corporate liabilities for debts under the domestic company laws under which the respective entities have been formed. The liability limitations under the respective applicable civil laws governing the legal entities involved that make up the firm, can be seen as some form of public subsidy. The liability limitation allows the firm involved to engage in taking commercial risks that have otherwise not been taken, i.e., without the available liability limitations. The allowance of greater risk-taking enables the firm that incorporated its business operations to potentially produce a higher return on investment.

As discussed in Chapter 2, the limitations in company law liabilities do not say anything about the volume of corporate profit produced. *"[T]he form of business organization may have nothing to do with the underlying unity or diversity of business enterprise."*[555] Accordingly, it should also be immaterial in calculating the taxable corporate profit – i.e., the neutrality of legal form.

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[552] Avi-Yonah refers to the firm's existence to argue that the imposition of a corporate tax is justified as a means to control the accumulation of economic power in the hands of corporate management. See Reuven S. Avi-Yonah, 'Corporations, Society and the State: A Defense of the Corporate Tax', 90 *Virginia Law Review* 1193 (2004), at 1193-1255.

[553] This may be considered true to the extent that it concerns a publicly or widely held company. With respect to a controlling shareholding of an individual in a privately or closely held company, the presence of a single economic operator may be argued to exist by reference to the ultimate shareholder/individual and the shareholding companies, i.e., as seen in conjunction. This may be the case where the investor/individual holds a controlling corporate interest in the company involved for the purpose of employing that controlling interest for the benefit of carrying on his underlying business enterprise on a continuing basis. This, as said, is not further discussed.

[554] See for a comparison Richard J. Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World', 2 *World Tax Journal* 291 (2010), at 293-294 linking this rationale to the theory of the firm.

[555] United States Supreme Court, *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S. Ct. 1223 (1980).

4.2.2 Multinational firms derive economic rents; the 'theory of the firm'

Moreover, as mentioned in Chapter 2 multinational firms are widely known to have the ability to produce economic rents. By operating their business activities in a financially, economically and organizationally integrated manner on a global scale, multinational firms have proven able to produce above-normal investment returns. These are commonly also referred to as 'pure profits', 'inframarginal' or 'returns', 'excess earnings', 'business cash-flow', or 'economic rents'; that is, investment returns in excess of the normal returns to the production factors of labor (wage) and capital.

Economic rents have been commonly explained by reference to the theory of the firm as originally stated by Coase.[556] The theory of the firm submits that substantively a multinational firm constitutes a single economic unit seeking to obtain and maximize economic rents on a global scale. Fueled by globalization, the multinational firm integrates or internalizes its business operations under an umbrella of common control to derive these rents, rather than outsourcing business functions to third market parties. The integration typically occurs both vertically and horizontally, i.e., respectively, the integration of activities within a single value chain and the integration of activities within two or more value chains.[557] Multinational integration generally occurs regardless of whether the firm involved operates its business enterprise through a branch structure or a subsidiary structure.[558]

There is an economic rationale for integrating or internalizing multinational business processes within the firm, rather than relying on market forces for these purposes: It is more profitable. The theory of the firm or internalization theory submits that the existence of multinationals can be explained by reference to the commercial benefits available from economic integration relative to market transactions.[559] The internalization of business activities takes place to avoid the costs that arise as a result of market inefficiencies that are apparent to third-party dealings, such as transaction costs involved, the costs of mutual trust issues and the costs of risk management.[560] The functional integration occurs to obviate these hazards external to the firm – e.g. quality control, security of information, and reputational issues. By internalizing business activities, multinationals are able to reduce costs accordingly through synergy by taking advantage of economies of scope and scale.[561]

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[556] See Ronald H. Coase, 'The Nature of the Firm', 4 *Economica* 386 (1937), at 386-405. See also Jean-Francois M. A. Hennart, 'Theories of the Multinational Enterprise', in Alan M. Rugman (Ed.), *Oxford Handbook of International Business* (2009), at 125-145.

[557] Vertical integration occurs when a multinational engages into two or more primary economic activities within the same value chain (e.g., manufacturing and distribution of a product or product line). Horizontal integration occurs when a multinational engages into economic activities within two or more value chains (e.g. manufacturing and distribution of two or more products or product lines). See for some discussion David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 1: The Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 55 (2004), at 58.

[558] Cf. 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 199, and Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275.

[559] Cf. Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines A Proposal for Reconciliation', 2 *World Tax Journal* 3 (2010), at 5.

[560] Cf. 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 239 and Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275. See also Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 8-9.

[561] See also Hubert M.A.L. Hamaekers, 'Arm's Length - How Long?', 8 *International Transfer Pricing Journal* 30 (2001), at 34. Further see Richard M. Bird, 'Shaping a New International Tax Order', 42 *Bulletin for International Fiscal Documentation* 292 (1988), at 292-299. See OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, respectively at par. 9.1. and 9.57 on the commercial rationales for business restructuring: *"Since the mid-90's, business restructurings have often involved the centralisation of intangible assets and of risks with the profit potential attached to them,"* and: *"Business representatives who participated in the OECD consultation process explained that multinational businesses, regardless of their products or sectors, increasingly needed to reorganize their structures to provide more centralized control and management of manufacturing, research and distribution functions. The pressure of competition in a globalised economy, savings from economies of scale, the need for specialization and the need to increase efficiency and lower costs were all described as important in driving business restructuring."* Cf. Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006),

These risks are managed through the common control. The common control is the instrument that is used to financially, economically and organizationally integrate the business activities of the aggregate of corporate entities into a single economic operator. The costs of market imperfections are minimized where interdependent business is brought under common ownership and control. This explains why multinationals arise where business integration through control mechanisms offers economic advantages over entering into market transactions.[562] Within the multinational enterprise market, transactions are eliminated and replaced by the entrepreneur coordinator. Effectively, this entails the supersession of the price mechanism due to the available costs savings from internalizing business.[563] The ability of avoiding (internalizing) transaction costs lies at the heart of the firm's structure. It provides economic advantages and the sources of profitability for the multinational firm.

In its BEPS Report referring to global business models, the OECD also recognizes the process of global integration of the multinational's business operation: *"Globalisation (…) has resulted in a shift from country specific operating models to global models based on matrix management organisations and integrated supply chains that centralise several functions at a regional or global level. (…) In today's MNEs the individual group companies undertake their activities within a framework of group policies and strategies that are set by the group as a whole. The separate legal entities forming the group operate as a single integrated enterprise following an overall business strategy."*[564]

4.2.3 This explains the unitary business approach in international tax theory

The notion of the firm as an economic single entity deriving economic rents explains why various commentators have resorted to advocating the unitary business approach;[565] that is the approach taken to come to a tax system in which, basically, the multinational group is treated as a single taxable entity for corporate tax purposes. Such an approach could be

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at 5, and Patrick Cauwenbergh et al, 'The New German Transfer Pricing Rules on Cross-Border Relocation of Functions: A Preliminary Analysis', 48 *European Taxation* 514 (2008), at 514, referring to the *"stripping out"* of functions.

[562] See Ronald H. Coase, 'The Nature of the Firm', 4 *Economica* 386 (1937), at 386-404 and Ronald H. Coase, 'Lectures on the Firm', 4 *Journal of Law, Economics & Organizations* 3 (1988), at 3-47. Langbein also refers to the Coase's theory of the firm to demonstrate his *"price continuum problem"*. See Stanley I. Langbein, 'The Unitary Method and the Myth of Arm's Length', 30 *Tax Notes* 625 (17 February 1986), at 666-667. Cf. Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 832-833. See also 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, as well as Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275.

[563] Notably, David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 1: The Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 55 (2004), at 58 refers to the benefits of integration as the 'OLI paradigm', i.e., the generally accepted microeconomic rationale for the emergence and international commercial successes of multinationals compared to independent enterprises by making reference to the advantages of available 'Ownership', the advantages of available alternative 'Locations' for production and the advantages of 'Internalization'.

[564] See OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing, 12 February 2013, at *25.*

[565] See e.g., Charles E. McLure, Jr., 'Economic Integration and European Taxation of Corporate Income at Source: Some Lessons from the U.S. Experience', 29 *European Taxation* 243 (1989), at 243-250, Mike McIntyre, 'Harmonizing Direct Taxes in the EEC', 2 *Tax Notes International* 131 (1990), at 131-132, Alicia Munnell, 'Taxation of Capital Income in a Global Economy: An Overview', *New England Economic Review* 33 (1992), at 33-51, Paul R. McDaniel, 'Formulary Taxation in the North American Free Trade Zone', 49 Tax Law Review 691 (1993-1994), at 691-744, Robert S. McIntyre et al, 'Using NAFTA to Introduce Formulary Apportionment', 6 *Tax Notes International* 851 (5 April 1993), at 851-856, Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 243-292, Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286, Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 103-111, François Vincent, 'Transfer Pricing and Attribution of Income to Permanent Establishments: the Case for Systematic Global Profit Splits (Just Don't Say Formulary Apportionment)', 53 *Canadian Tax Journal* 409 (2005), Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', 62 *Bulletin for International Taxation* 201 (2008), at 201-215, and Maarten F. de Wilde, 'A Step towards a Fair Corporate Taxation of Groups in the Emerging Global Market', 39 *Intertax* 62 (2011).

achieved technically by means of a cross-border tax consolidation or an otherwise cross-border aggregation of taxable profits.[566]

As the firm constitutes a single economic entity, it should perhaps be treated as a single entity as well. And as the firm creates rents, it seems sensible to tax these rents from the firm directly through the corporate tax system, rather than indirectly from its portfolio shareholders. The firm as the economic entrepreneur would be taxed accordingly for its returns on the production factor of enterprise; this would contribute to the finance of public goods and services provided by the state, from which it also benefits.

4.3 Tax consolidation remedies the separate entity approach's distortive features

4.3.1 Seeking to capture multinationals for corporate tax purposes

4.3.1.1 Taxing multinationals on the basis of a common tool; the separate entity approach

The international corporate tax systems of basically all modern democratic constitutional nation states share a common objective: They all seek to effectively 'capture' the multinationals that are economically present within the respective taxing state's geographical borders for corporate tax purposes. Basically all tax jurisdictions attempt to geographically localize business activities and the business income produced. The purpose is to ensure that business income generated within the territory of the taxing state is taxed by that state. Business income generated outside that state's territory – i.e., foreign source income – is generally intended to be excluded from domestic taxation.

States have established their international tax systems on common building blocks to attain this objective. As a general rule, taxable corporate bodies are individually taxed on their earnings, i.e., the (functionally) separate entity approach or the classical system of corporate taxation. Typical examples of taxable corporate bodies are publicly and privately held limited liability companies. Partnerships generally are tax transparent. This holds save for a range of exceptions. Some countries consider limited liability companies tax transparent. Some countries provide tax transparency even by option. Others consider (limited) partnerships to constitute corporate taxpayers. As addressed in Chapter 1, matters differ greatly by country in this area. No legal paradigm exists. The absence of a paradigm lies at the heart of the hybrid entity mismatch issues in the international tax regime. These essentially are the result of the lack of a paradigm in the design of the taxable entity for corporation tax purposes.

4.3.1.2 The separate entity approach produces arbitrage

The approach of subjecting corporate bodies as separate taxable entities to corporate taxation holds up regardless of whether the corporate bodies involved are part of a functionally integrated multinational firm. This is particularly true in cross-border environments.

It follows that under the operation of the classical system of corporate taxation, states arbitrarily affect corporate tax burdens and revenue levels. First, firms are tax-treated differently, depending on their legal structuring. This influences decisions regarding the choice of legal forms. Second, the corporate tax implications differ depending on whether the economic activities of the firm involved are performed in a (non-)cross-border context. States, for instance, subject corporate taxpayers that are part of a group to different tax burdens depending on their place of incorporation or place of tax residence, the place of tax residence of their corporate affiliates, or whether the firm's business operations involved are conducted across various tax jurisdictions. These respectively produce (in)direct discrimination issues, so-called second-tier discrimination issues, and jurisdiction entry and exit restriction issues.

[566] See, e.g., Maarten F. de Wilde, 'A Step towards a Fair Corporate Taxation of Groups in the Emerging Global Market', 39 *Intertax* 62 (2011).

The tax differentials imposed affect the corporate decision of the firm involved as to whether or not to cross the tax border. Accordingly, this affects the corporate tax burden imposed. From this it follows that corporate taxation influences the distribution of the production factors of capital and labor. This in turn affects the corporate tax revenues of countries.

The arbitrary tax differentials in corporate taxation may work out for the benefit or to the detriment of individual multinationals or tax administrations in individual cases. Well-advised multinationals may even be able to tax-structure their way around the distortive features of the international tax regime. They perhaps may even be able to have the system operate to their benefit, for instance by making use of the disparities in taxable entity classifications, i.e., the use of hybrid entity mismatches in tax-optimization. Multinationals accordingly may be able to influence the effective average tax rates they are subject to in the countries within which they are economically active.[567]

If observed as a whole, it can nevertheless be said that the international tax systems of states distort the functionality of domestic markets, the internal market within the European Union and the emerging global market. This is problematic for all parties involved in the corporate taxation of proceeds from multinational business operations. The steady flow of the Court of Justice's case law on the fundamental freedoms in the field of direct taxation in European Union cases may be considered a noteworthy illustration of this. As mentioned in the introduction of this study, perhaps, everyone may pay at the end of the day.

4.3.1.3 Some elaboration; effects of distorting separate entity approach is inefficient and inequitable

Please let me devote some additional words on the distortive effects of the utilization of the separate entity approach in corporate taxation. As said, typically, states maintain the approach of taxing corporate entities on an individual basis if these entities belong to a group.[568] This influences the group's decisions on the manner in which it (legally) arranges its business affairs. The separate entity approach distorts the choice of legal form.[569]

A comparison between a group of affiliated corporate entities operating a business enterprise and a single corporate entity operating a business enterprise reveals that the separate entity approach entails different corporate tax treatment in comparable circumstances. Groups and single entities are taxed differently, despite the fact that they are subject to equal economic circumstances.

Legal transactions between the corporate affiliates – intra-firm inter-entity transactions – are recognized as a taxable event for corporate tax purposes. An arm's length transfer price needs to be considered with respect to intra-group provision of services and supply of goods. This typically holds in both domestic and cross-border economic environments.

This is not the case with the equivalent 'dealings' between the branches of a single legal entity, i.e., intra-firm intra-entity dealings. Intra-firm dealings are disregarded for corporate tax purposes. This holds at least to the extent that these internal dealings occur within a single tax jurisdiction. In cross-border environments, permanent establishments are hypothesized for profit attribution purposes as separate enterprises operating distinctly from the taxable corporate body of which it is legally part, i.e., the 'functionally separate entity approach'. In such cases internal dealings are recognized in corporate taxation.

Furthermore, the intra-group distributions of after-tax corporate earnings that are issued for the purpose of reinvesting the means available in the firm's multinational business enterprise

[567] See for some elaborate analyses on the matter OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing, 12 February 2013.
[568] See for a comparison Wolfgang Schön, 'International Tax Coordination for a Second-Best World (Part II)', *2 World Tax Journal* 65 (2010), at 71 and Andreas Oestreicher et al, 'How to Reform Taxation of Corporate Groups in Europe', 3 *World Tax Journal* 5 (2011), at 5-38.
[569] See for a comparison Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010), at section 3.

are considered taxable events as well. This, for instance, holds up in regards to intra-firm dividends and intra-firm capital gains on intra-firm shareholding interests. No such taxable event occurs where a single entity reinvests its branches' after-tax earnings in the single entity's business enterprise.

Moreover, where the aggregation of the business income earned through branches of a single corporate body is granted, such an aggregation for corporate tax purposes of the group's business income is unavailable – i.e., an aggregation of losses and profits realized by the various affiliates within the tax year, or 'horizontal loss-compensation'.

As a consequence of this, when multinational groups of affiliated corporate bodies are taxed under the classical system they are put at a competitive disadvantage comparatively due to the differential corporate tax treatment relative to the tax-treatment of single corporate bodies. This in effect results in liquidity and cash flow disadvantages as well as the economic double taxation of the business income realized by the firm involved. Groups of affiliated corporate bodies and single corporate bodies are subject to a different tax burden in comparable circumstances. This is both inefficient and inequitable.

4.3.1.4 Countering the arbitrage; tax consolidation

Tax consolidation reinforces the neutrality of the legal form in corporate taxation

Fortunately, the tax legislators in various states recognize the distorting effects that the application of the separate entity approach to groups entails. Equity and economic efficiency considerations inspired several legislators to remedy the distortions through the application of tax consolidation regimes for groups of companies, thereby neutralizing intra-firm legal realities for corporate tax purposes.[570] This makes economic sense because internal transactions do not contribute to the firm's profit making.[571] Notably, the consolidation technique used in corporate taxation is the same as their widely known equivalents in commercial accounting, i.e., essentially a relatively straightforward procedure finding its origins in long standing accounting practices.[572]

Without the intention of being conclusive, tax consolidation regimes can, for example, be found in the international tax systems of France ('régime de l'intégration fiscale' and 'regime du bénéfice mondial consolidé),[573] Italy ('consolidato fiscale nazionale' and 'consolidato mondiale'),[574] Luxembourg (régime d'intégration fiscale),[575] the Netherlands ('fiscale-eenheidsregime'),[576] the United States ('privilege to file consolidated returns'),[577] Australia

[570] On group taxation, see the observations of general reporter Masui in International Fiscal Association, *Cahiers de Droit Fiscal International* (*Volume 89b*, *Subject II (Group taxation))* (2004). In distinguishing group taxation regimes, Masui distinguishes the 'Organschaft', 'group contribution', 'group relief' and the 'consolidation model' at 29. In this chapter the focus lies on tax consolidation as this is the only model conceptually paving the way to recognize the group as a single taxable entity and with that to fully appreciate the unitary business approach. At the end of day the other approaches referred to all are profit-pooling regimes certainly deviating from the separate entity approach yet not recognizing the unitary business approach to its full extent conceptually since intra-group legal transactions in their essence maintain to be recognized for corporate tax purposes.

[571] See for a conceptually similar argument in the context of formulary apportionment under the sales factor, Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 53: *"Logically, intra-group sales should be excluded (…) as only third-party unrelated sales have contributed to the net group profits that the factor seeks to apportion."*

[572] For a similar argument submitted by a tax practitioner regarding the consolidation technique to be employed under the CCCTB Proposal, see Thies Sanders, 'Consolidation in the CCCTB Proposal', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 1, at 1-10.

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

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

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

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

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

('consolidated groups'),[578] New Zealand ('consolidated groups of companies')[579] and Japan ('consolidated tax return filing system').[580] Moreover, the efforts of the European Commission to adopt a harmonized corporate tax base for European business enterprises in combination with a tax consolidation regime, referred to as the Common Consolidated Corporate Tax Base or CCCTB, should be mentioned here as well. Also the CCCTB provides for a tax-consolidation mechanism.

The application of a full tax consolidation regime whereby intra-group transactions are eliminated for tax calculation purposes basically entails the acknowledgement of the business economics reality of the group as one economic operator operating an integrated business enterprise for corporate tax purposes. Essentially, the unitary business approach is adopted as a correction mechanism for the distortive effects that ensue from making use of the separate entity approach as a point of departure. Indeed, *"[t]he (…) rationale for taxing affiliated companies on a consolidated basis is acknowledging the fact that taxing businesses on a separate entity approach artificially divides up the profits earned by unitary enterprises."*[581]

Full tax consolidation analytically has the effect that the group of affiliated corporate entities is treated as a single entity for corporate tax purposes and accordingly regarded as the taxable entity. The corporate veils are being pierced for corporate tax purposes. The parent company constitutes the taxpayer; all affiliated corporate entities are effectively tax transparent – i.e., the 'all-in approach'.

As a result of the tax consolidation procedure, the group of affiliated corporate bodies is taxed in the same manner as a single corporate body conducting its business enterprise through branches. Tax consolidation allows for the aggregation of losses and profits realized by the various affiliates within the tax year. Furthermore, tax consolidation takes back the initial recognition of intra-group transactions for corporate tax purposes.

As a result thereof, tax consolidation allows groups to organize their business affairs (legally) to meet their commercial needs without the distortion of corporate taxation. The single taxation of the business income of groups is achieved in an equitable and economically efficient manner. The market distortions that ensue from applying the separate entity approach are resolved. Economically comparable circumstances are treated equally for corporate tax purposes. Economic reality is appreciated. This is both efficient and equitable.

Tax consolidation resolves the arbitrage potential in recognizing intra-group (financing) transactions

Tax consolidation also resolves the market distortions that occur from the arbitrary yet commonly applied differences in the corporate tax treatment of proceeds from debt and equity financing arrangements within groups of affiliated corporate entities.[582] On the one hand, most international corporate tax systems effectively do not tax the proceeds from intra-firm equity financing arrangements, i.e., the exemption of dividend receipts and capital gains on (substantial) corporate shareholders interests. But on the other hand, these often do recognize for corporate tax purposes intra-firm debt financing arrangements, i.e., the taxation

[578] See Division 703 (Consolidated groups and their members) of the Australian Income Tax Assessment Act 1997 ('Australian IITA 1997'). See also Division 719 (MEC groups) Australian IITA 1997 with respect to the formation of consolidated groups of wholly owned subsidiaries of a foreign tax resident parent company (a 'multiple entry consolidated ('MEC') group').
[579] See Subpart FM (Consolidated groups of companies) of the New Zealand Income Tax Act 2007 ('New Zealand ITA').
[580] See Article 4-2 (Consolidated taxpayer) of the Japanese Corporation Tax Act ('Japanese CTL').
[581] See for a comparison Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 178.
[582] On the responsiveness to taxation of intra-firm financing, see Thomas Kollruss, 'International Tax Law and the Multinational Capital Structure: Evidence from US MNCs German Direct Investment', 40 *Intertax* 192 (2012), at 192-199. See also International Monetary Fund, *IMF Policy Paper; Spillovers in International Corporate Taxation*, International Monetary Fund, Washington, D.C., 2014, at 23-24: *"Tax planning through intra-group borrowing amplifies (unconsolidated) leverage, but may impose few financial stability risks. Such borrowing affects the apparent allocation of risk within the group, but, implicitly if not explicitly, risk is likely borne at the group level, so that lending to affiliates is akin – in all but tax terms – to an equity investment."*

of interest receipts and the allowance of tax-deductible interest payments and impairments of receivables.[583]

Tax consolidation remedies this arbitrary corporate tax treatment, that is, at least to the extent that it concerns intra-group debt and equity financing arrangements. The undertaking of financing arrangements within a group of affiliated corporate entities should not be recognized for corporate tax purposes as they do not affect the overall business profit realized by the group. Intra-group dividend streams or interest payments do not add value to the economic entity. Hence, there is no economic reality that could support the recognition of intra-group interest payments or dividend distributions for corporate tax purposes.

Under the separate entity approach, however, intra-group financing arrangements are recognized for corporate tax purposes. This effect is remedied when tax consolidation is applied. After all, derecognizing intra-group transactions for corporate tax purposes entails that intra-group debt and equity financing arrangements are derecognized as well.

Distortive effects are kept in place where tax-consolidation is not made available

The aforementioned distortions are kept in place in cases where a state's international tax system does not allow groups to be regarded as a single taxable entity under a tax consolidation regime. This may be the case when the respective taxing state simply does not have a tax consolidation regime available in its international tax system, or where it does not allow a group to apply the tax consolidation regime and form a consolidated tax group under the terms of the regime's application, even though the group involved operates economically as a single entity.

In such cases, the separate entity approach is maintained. Liquidity (cash flow) disadvantages and the economic double taxation of the business income realized by the group will then be the inevitable consequence.

Seeking to resolve the arbitrage by means of halfway mechanisms

Disregarding proceeds from intra-firm equity investments; common

In scenarios where firms are not enabled to form a consolidated tax group, states commonly counter the resulting distortions on the basis of alternative, specific or ad hoc, correction mechanisms, all of which have been introduced for equity and/or economic efficiency reasons. For example, the single taxation of proceeds from equity interests in non-tax consolidated group companies - such as intra-group dividends and capital gains - is commonly achieved by states on the basis of an indirect credit or a participation exemption mechanism. These regularly apply in conjunction with the application of a 0% dividend tax rate or dividend tax exemption with respect to intra-group dividend distributions.

Participation exemption regimes can, for example, be found in Australia[584] Luxembourg,[585] the Netherlands,[586] France,[587] Belgium,[588] Austria,[589] Denmark,[590] Finland,[591] Norway,[592]

[583] See Wolfgang Schön, 'International Tax Coordination for a Second-Best World (Part II)', *2 World Tax Journal* 65 (2010), at 74-76. See on the matter further Ruud de Mooij et al, 'An applied analysis of ACE and CBIT reform in the EU', *CPB Discussion Papers 2009:128*. Moreover, see for a comparison A. Van der Horst et al, 'Een macro-economische analyse van renteaftrek in de Vpb', 138 *Weekblad Fiscaal Recht* 948 (2009), at section 2. Notably, the Dutch government for instance has been struggling with the distortive consequences of these arbitrary differences in corporate tax treatment since the Court of Justice rendered its decision in case C-168/01 (*Bosal*). See the Letter of the Dutch State Secretary for Finance to Parliament of 15 June 2009, DB/2009/227U and the Letter of the Dutch State Secretary for Finance to Parliament of 5 December 2009, DB2009/674M. As of 1 January 2013, the Dutch tax legislator has introduced a targeted interest deduction limitation in the Netherlands' international tax regime that specifically seeks to strike down the arbitrage at this point. The measure conceptually lies somewhere in-between a thin capitalization measure and an earnings and stripping measure. The provision is not further discussed. For some further analysis of the underlying issue in cross-border environments and the resolving of it via alternative means – i.e., through the cross-border tax consolidation of majority interests and re minority interests by means of an economic double tax relief mechanism referred to as the 'indirect tax exemption' – see respectively section 6.5.1.2 and section 5.4.4.3.

[584] See section 23AJ (Certain non-portfolio dividends from foreign countries not assessable) Income Tax Assessment Act 1936 ('Australian IITA 1936') and Subdivision 768-G (Reduction in capital gains and losses arising from Capital

Germany,[593] Italy[594] Spain,[595] and Japan.[596] (Dividend) imputation credit regimes can, for example, be found in New Zealand[597] and the United States.[598] The European Union Parent Subsidiary Directive, requiring the Member States to adopt an exemption or indirect credit mechanism with respect to inter-company dividend distributions can be mentioned in this respect as well. These are accompanied with a dividend withholding tax exemption.

Disregarding proceeds from intra-firm debt investments; uncommon

Notably, mechanisms exempting proceeds from intra-group debt interests such as interest expenses, interest receipts and impairment losses on debt receivables – introduced for the purpose of removing the arbitrary differences in the corporate tax treatment of income from debt and equity financing – are quite rare.

Gains Tax events in relation to certain voting interests in active foreign companies) Australian IITA 1997, providing for relief for dividend income and capital gains on the disposal of shares. Eligibility criteria are left out of consideration.

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

[586] See Article 13 Dutch CITA. Under its participation exemption regime the Netherlands applies a full exemption both with respect to dividends and capital gains on shares. Eligibility criteria are left out of consideration. See for some details Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international (*2011), at sections 1 and 3.

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

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

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

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

[591] See §§6-6b of the Finnish Business Income Tax Act ('Lag om beskattning av inkomst av näringsverksamhet' or 'NSL'). Under its participation exemption regime Finland applies a full exemption both with respect to dividends and capital gains on shares. Eligibility criteria are left out of consideration. For details see Thor Leegaard, 'Taxation of Corporate Shareholders in the Nordic Countries – part 1', 47 *European Taxation* 126 (2007), at 126-134 and Thor Leegaard, 'Taxation of Corporate Shareholders in the Nordic Countries – part 2', 47 *European Taxation* 178 (2007), at 178-186.

[592] See §2-38 of the Norwegian Skatteloven ('Norwegian Tax Act' or 'Norwegian TA'). Under its participation exemption regime Norway generally applies a full exemption both with respect to dividends and capital gains on shares. Eligibility criteria are left out of consideration. For details see Thor Leegaard, 'Taxation of Corporate Shareholders in the Nordic Countries – part 1', 47 *European Taxation* 126 (2007)at 126-134 and Thor Leegaard, 'Taxation of Corporate Shareholders in the Nordic Countries – part 2', 47 *European Taxation* 178 (2007), at 178-186.

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

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

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

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

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

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

Some examples could be found in Hungary and the Netherlands. In Hungary a 50% exemption for intra-group interest payments had been in place for some time. This regime has been repealed as of 1 January 2010.[599] In the past, The Netherlands tax legislator had proposed and later withdrawn the so-called 'mandatory group interest box'.[600] The regime would have allowed for an 80% exemption for proceeds from intra-group debt arrangements.

The utilization of interest deduction limitations; common

Instead of derecognizing intra-group debt arrangements for corporate tax purposes altogether, nation states commonly have put interest deduction limitation regimes in place to counter the arbitrary creation of deductible interest expenses by taxpayers attempting to reduce their local corporate tax bases and/or shifting the locally produced corporate income to low-taxing jurisdictions.

Thin capitalization measures and earnings-stripping rules are noteworthy examples of commonly applied correction mechanisms.[601] Thin capitalization regimes can for instance be found respectively in the international tax systems of Denmark, France, Spain, Australia, New Zealand and Japan.[602] Earnings and stripping rules can be found in the international tax systems of Denmark, Germany, Italy and the United States, as well as in the suggested alternatives to the CCCTB proposal forwarded by the Presidency of the Council.[603] These measures have in common that they apply where corporate taxpayers take-up (intra-group) loans producing tax-deductible interest payments to levels that are considered inappropriate by the respective tax jurisdictions involved.

The utilization of profit-pooling regimes; quite common

Moreover, it is not uncommon in the international tax regime that the international tax systems for states allow for an aggregation of the group's business income. This is made available in a variety of states on the basis of so-called 'profit-pooling regimes' or tax-grouping regimes.

Examples of tax-grouping regimes allowing for an aggregation of income realized by the various group companies can be found in Germany ('Organschaft'),[604] Austria ('Organschaft'),[605] the United Kingdom and Ireland ('group relief regime'),[606] Portugal ('Regime Especial de Tributação de Grupo de Sociedades'),[607] Denmark ('national' and 'international joint taxation regime'),[608] Norway[609] and Finland[610] ('group contribution regime'). Further noteworthy examples can be found in US state income where various US states allow

[599] For some details see Roland Felkai, 'Hungary, 2010 Tax Changes', 49 *European Taxation* 611 (2009), at 611-613.
[600] The Dutch group interest box was proposed in the Letter of the Dutch State Secretary for Finance to Parliament of 15 June 2009, DB/2009/227U and subsequently withdrawn in the Letter of the Dutch State Secretary for Finance to Parliament of 5 December 2009, DB2009/674M.
[601] For an analysis of the efficacy of thin capitalization mechanisms in place in Germany and the United Kingdom, see Claus-Peter Knöller, 'The Efficacy of Thin Capitalization Rules and Their Barriers: An Analysis from the UK and German Perspective', 39 *Intertax* 317 (2001, No. 6/7), at 317-336.
[602] The regimes can be found respectively in §11 Danish CTA, Article 212 French CGI, Article 20 Spanish CITA'), Division 820 (Thin capitalization rules) Australian IITA 1997, subpart FE (Interest apportionment on thin capitalisation) New Zealand ITA and Article 66-5 Japanese Special Taxation Measures Law ('Japanese SMTL'). Until 2013 the Netherlands' international tax regime contained a thin capitalization regime in Article 10d Dutch CITA. This regime has been replaced as of 2013 by the aforementioned Article 13l Dutch CITA.
[603] Respectively to be found in §11C Danish CTA, §4h of the German Einkommensteuergesetz ('German Income Tax Code' or 'EStG'), articles 167 and 168 of the Italian Tax Code and §163(j) (Limitation on deduction for interest on certain indebtedness) US IRC. The earnings and stripping provision (Article 14a) suggested by the Presidency of the Council can be found in the comments of the Presidency of the Council on the CCCTB proporsal (doc. 8387/12 FISC 49) published by the Council of the European Union, 16 April 2012, no. 2011/0058(CNS).
[604] See §§14–19 German Corporate Tax Code. Eligibility criteria are left out of consideration.
[605] See §9 Austrian Corporate Tax Code. Eligibility criteria are left out of consideration. See for details on the functioning of the Austrian regime Werner Wiesner et al, *Gruppenbesteuerung: Praxiskommentar* (2005).
[606] See Part 5 of the United Kingdom's Corporation Tax Act 2010 ('UK CTA') and Section 420 of the Irish Taxes Consolidation Act 1997 ('Irish TCA'). Eligibility criteria are left out of consideration.
[607] See Articles 69-71 of the Portuguese Imposto sobre o rendimento das pessoas colectivas ('Portuguese Corporate Tax Act' or 'Portuguese IRC'. Eligibility criteria are left out of consideration.
[608] See §31 and 31A Danish CTA. Eligibility criteria are left out of consideration.
[609] See §§10-2 to 10-4 Norwegian TA. Eligibility criteria are left out of consideration.
[610] See Articles 1-8 of the Finnish Law on Intra-group Financial Transfers (Laki konserniavustuksesta verotuksessa of 21 November 1986 ('Finnish KonsAvL'). Eligibility criteria are left out of consideration.

for the pooling of the corporate profits of affiliated corporate bodies under the concept of combined reporting.[611]

The utilization of shareholding impairments; not too common

As an alternative means to profit-pooling regimes, some nation states allow for a tax deductible impairment of equity interests in respect of (foreign) loss-making subsidiary companies, for instance Spain, and The Netherlands until 2007.[612] To secure the single taxation of the underlying business income, the tax-deductibility is typically paired with a recapture mechanism .

As an alternative for the allowance of a deduction of losses at the level of a shareholding company when realized, some countries make such a loss-offset available upon the liquidation of a loss-making non-consolidated (foreign) group company. An example of such a regime can be found in the current international tax system of The Netherlands, i.e., the 'liquidation losses set-off regime'.[613]

The allowance of tax-free intra-group asset transfers; quite common

Furthermore, some nation states allow for tax-neutral asset transfers between group companies. These are made possible, for instance, in the international tax systems of the United Kingdom and Ireland under the so-called 'capital gains tax group relief regime'.[614]

The capital gains tax group relief regime in place in these countries allows groups of affiliated corporate bodies to transfer assets amongst the affiliates on a no gain/no loss basis. That is to the extent that the transferred assets remain within the charge of the corporation tax, respectively, of the United Kingdom and Ireland. The objective of the eligibility requirement that the assets involved have to remain situated within these states' territories is to ensure that the hidden reserves contained in the assets involved do not escape British or Irish corporate taxation. The eligibility requirement in the respective tax systems essentially is an expression of an import neutrality promoting territorial tax system.

Correction mechanisms common property: resolving distortive effects of separate entity approach on ad hoc basis

These alternative correction mechanisms can all be seen as examples of approaches conceptually moving away from the separate entity approach towards a unitary business approach. On the basis of the same equity and economic efficiency arguments underlying tax consolidation regimes, these alternative measures deviate from the starting point that each group company is treated as a single taxpayer. That is, at least to some extent.

But contrary to tax consolidation, they do not fully appreciate the economic integration of the affiliated corporate entities into one single economic operator. That is, as these alternative

[611] See for some reading and analysis, e.g., Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, who describes the concept of combined reporting at 256: *"The basic theory of combined reporting is that the income earned by a group of related corporations engaged in a common enterprise is, in substance, the income of the enterprise, not the income of the various members that make up that enterprise. The members of the enterprise are established for various intra-group reasons. The branches and affiliates that make up the enterprise, however, are merely tools used by the enterprise for earning income, just as ownership of equipment is a tool used by the enterprise for earning income. There may be legal reasons for attributing a portion of the income of the enterprise to one or more members, typically to facilitate collection of the taxes assessed. In an apportionment formula, there also may be a reason for linking income with equipment or other property. These attribution rules, however, are not fundamental in determining the taxes paid by the enterprise. What is fundamental is the determination of the total income of the enterprise and the attribution of that income to various taxing jurisdictions based on the characteristics (factors) of the enterprise as a whole."*

[612] See Article 13ca Dutch CITA (2006).

[613] See Article 13d Dutch CITA. Eligibility criteria are left out of consideration. For some analysis see Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international (*2011), at section 2.3.2.

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

measures only counter some specific distortive effects that the adoption of the separate entity approach entails. The separate entity approach has not been abandoned completely and the unitary business approach has not been adopted to its full extent.

These alternative correction mechanisms are basically 'per-element solutions' combating the symptoms that are caused by the underlying problems that ensue from taxing affiliated corporate entities on an individual basis. They can therefore be considered examples of 'halfway approaches' conceptually ending up somewhere in the middle between the separate entity approach and the unitary business approach. And with that, these alternative measures may also be considered 'halfway solutions' for the problems that the underlying separate entity approach causes when groups of companies are being taxed by states in today's globalizing economy.

For that reason, the correction mechanisms alternative to tax consolidation are left out of any further consideration in this paper. The focus lies on tax consolidation for the concept providing a comprehensive solution to the distortive effects of the separate entity approach.

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

4.4.1 Reconsidering the scope of application of the typical tax consolidation regimes

To remedy the distortions that ensue from the utilization of the separate entity approach in the international tax regime, the tax consolidation regime should not only be present within an international tax system of a state. It should also be designed in a manner that adequately covers the economic entity, i.e., the group of affiliated corporate entities that have been integrated into one economic operator.

The purpose of this section is to attempt to demonstrate that – where present in the current international tax systems of nation states – the tax consolidation regimes often do not adequately cover the economic entity when it involves the corporate taxation of groups of affiliated corporate bodies. This results in market distortions.

This is true in both domestic and cross-border contexts. Consequently, the scope of application of the tax consolidation regimes as typically put in place in the international tax systems of states needs to be reconsidered. In the following subsections 4.4.2 (domestic context) and 4.4.3 (cross-border context), the objective is to provide for an equitable and efficient model tax consolidation framework; that is to adequately identify the economic entity as a single taxable entity under a corporation tax 2.0 meeting the requirements of a global market environment.

4.4.2 Remedying distortive effects in a domestic context

4.4.2.1 Decisive influence

Addressing common control

When determining the scope of application of a tax consolidation regime, states allowing for tax consolidation – to my impression – seek to express the power of the parent company to direct their subsidiaries' business activities. That is, they seek to address that the operations of the group of economically integrated corporate entities take place under the common control of the ultimate parent company.[615]

[615] See for a comparison Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation', *University of Michigan Law School*, *John M*, *Olin Center for Law & Economics*, Working Paper No. 07-017 (2007), at section IV, and Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global

Expressing control via shareholding volume test; examples

In an attempt to identify the group or economic entity to which the respective tax consolidation regime may subsequently apply, several tax legislators have introduced requirements that address the volume of shares (in)directly held by the respective parent company in their subsidiaries.[616]

The shareholding interests required for tax consolidation vary widely and range between 50% or more and 100%. Italy for example, requires a shareholding interest exceeding 50% in the corporate entity's equity capital.[617] In the CCCTB proposal a two-part test applies, i.e., the right to exercise more than 50% of the voting rights and an ownership right amounting to more than 75% of the company's capital or more than 75% of the rights giving entitlement to profit.[618] The United States requires a shareholders' interest representing 80% or more of the total value and voting power of the stock of the company in which the shares are held.[619] The Dutch 'fiscale-eenheidsregime' and the French' 'régime de l'intégration fiscale' call for a shareholders' interest of at least 95%.[620] In Japan, Australia and New Zealand, only wholly owned companies are eligible to form a consolidated tax group.[621]

Easy to apply yet necessarily insufficient to adequately express control

With such relatively easy-to-apply shareholding volume requirements, as said, it is my impression that tax legislators seek to express the power of the parent company over the organization and management of the underlying business activities of the subsidiaries in which the shares are held. Namely, the parent company's control over the financial, economic and organizational affairs of the (sub)subsidiaries is the necessary means with which the intended economic integration of the group is shaped.[622] The property rights attached to the shares that provide the shareholder with a say in the corporate entity's business – such as the voting rights in the shareholders meeting and/or rights of appointment and dismissal of executives – provide for the required power to direct the underlying business activities.

However, although having the advantage of administrative simplicity with the easy application for a shareholding volume, the level of shares held by the shareholder merely provides for an indication of the level of power. The power of the shareholder to steer the underlying business activities of its subsidiary does not necessarily vary directly in proportion to the volume of shares held.[623] This is due to the fact that economic power can be manifested in numerous (legal) ways.

In practice, for example, it is possible to establish various types of property rights regarding the say in the shareholders meeting to various types of shares. Moreover, the say in a corporate business may even be founded on property rights other than equity interests (e.g. on contractual arrangements). Mentionable examples in this respect are group agreements ('Beherrschungsvertrag'), or (voting) arrangements amongst shareholders and/or between

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Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 12 and 20.

[616] See also Wolfgang Schön, 'International Tax Coordination for a Second-Best World (Part II)', *2 World Tax Journal* 65 (2010), at 66.

[617] See Articles 117-142 Italian Tax Code.

[618] See Article 54(1) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). See for a comparison Common Consolidated Corporate Tax Base Working group (CCCTB WG) Working Paper No. 57, *CCCTB: possible elements of a technical outline,* Taxud E1, CCCTB/WP057\doc\en, Brussels, 26 July 2007.

[619] See §1504 (Consolidated Returns) US IRC.

[620] See respectively Article 15 Dutch CITA and Article 223A French CGI.

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

[622] See Reuven S. Avi-Yonah, 'The Structure of International Taxation: A Proposal for Simplification', 74 *Texas Law Review* 1301 (1996), at 1309, as well as OECD Investment Division, Directorate for Financial and Enterprise Affairs, *OECD Benchmark Definition of Foreign Direct Investment*, 4th Edition, OECD, Paris, 2008, at 15.

[623] Under German company law for instance a 25% minority can block pivotal corporate business decisions; see Sections 179(2) and 262(1) no. 2 of the German AktG.

shareholders and persons having other corporate (e.g. debt) interests in the business enterprise.

Consequently, the size of the shareholding may – in effect – be indifferent in determining whether the respective corporate entities are economically integrated into one economic entity. The potential consequence is arbitrage: it may allow a firm to legally arrange its business affairs in a manner that avoids corporate taxation.[624]

At the end of the day, only the actual economic power counts. As a result of this, all shareholding volume requirements will ultimately prove to be arbitrary.[625] Therefore, in my view, a shareholding volume criterion alone is not suitable for identifying the group for the purpose of applying the corporate tax consolidation.

Expressing control via decisive influence test

In order to bring about the economic integration into a group, the parent company needs to have some form of corporate interest that gives it in fact a decisive influence on the underlying business affairs of its (sub)subsidiaries (centralization of management). Only in that case may the financial, organizational and economic integration of the aggregate of corporate entities into one economic entity operating one business enterprise be present. And only in the situation where the parent company has a decisive influence may the aggregate of corporate entities be comparable with a single entity that operates its business enterprise through one or more branches.

Namely, from a business economics perspective, there is no difference between operating a business enterprise (directly) through a branch or (indirectly) through the branch of a controlled group company. Notably, the aforementioned may also explain the reason why the Court of Justice adopted its 'definite influence and control test' or 'Baars criterion' under the freedom of establishment in its case law on fundamental freedoms in the field of direct taxation, preceding its comparison between a secondary establishment of an economic operator through a permanent establishment or a group company.[626]

These observations boil down to the position that tax consolidation should, as a rule, be allowed with respect to corporate interests that provide the parent company with a decisive influence over the underlying business affairs of its subsidiaries.[627]

A decisive influence criterion may cause some legal uncertainty.[628] This effect however should not be overstated. For instance, it also commonly applies in commercial accounting.

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[624] Cf. Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 267.

[625] See for a comparison F.A. Engelen et al, 'Wijziging van belastingwetten met het oog op het tegengaan van uitholling van de belastinggrondslag en het verbeteren van het fiscale vestigingsklimaat', 137 *Weekblad Fiscaal Recht* 891 (2008). The authors suggest a similar criterion – a corporate interest of 'more than half' –to define an affiliate corporate entity under their proposals for a set of group interest deduction limitations alternative to those currently found in the Netherlands' international tax regime.

[626] See Court of Justice, cases C-251/98 (*Baars*), C-307/97 (*Saint-Gobain*), C-446/04 (*FII*), C-524/04 (*Thin Cap GLO*), C-157/05 (Holböck), C-298/05 (Columbus), C-284/06 (Burda), C-182/08 (*Glaxo*) C-311/08 (*SGI*), and C-35/11 (*Test Claimants in the FII Group Litigation – FII 2*). On the concurrent application of the fundamental freedoms, see Erwin Nijkeuter et al, 'FII 2 and the Applicable Freedoms of Movement in Third Country Situations', 22 *EC Tax Review* 250 (2013), at 250-257, and Daniel S. Smit, 'The relationship between the free movement of capital and the other EC Treaty freedoms in third country relationships in the field of direct taxation: a question of exclusivity, parallelism or causality?', 16 *EC Tax Review* 252 (2007).

[627] See for a comparison International Accounting Standards ('IAS') 27 ('Consolidated and Separate Financial Statements') on the basis of which a 'control' test has been adopted to identify the group of affiliated entities required to present its financial statements as those of a single economic entity (consolidated financial statements). See also the Letter of the Dutch State Secretary for Finance to Parliament of 15 June 2009, DB/2009/227U in which the Dutch State Secretary for Finance chose a decisive influence criterion in the draft proposal for a mandatory group interest box (an 80% base exemption for proceeds on intra-group debt capital arrangements). Note that the group interest proposal was withdrawn in the Letter of the Dutch State Secretary for Finance to Parliament of 5 December 2009, DB2009/674M.

[628] For some analysis on the question as to whether to adopt a legal test or an economic test for tax grouping purposes, see e.g., Charles E. Mclure, Jr., 'Corporate Tax Harmonization in the European Union: The Commission's

Indeed, inspiration for the interpretation of such a decisive influence criterion may be found in the control test as commonly applied under commercial accounting consolidation rules (e.g. IAS 27). Moreover, a decisive influence criterion cannot be manipulated as easily as is the case with a shareholding volume criterion. Therefore, a decisive influence criterion should be favored over a shareholding criterion. Notably, in addition to this criterion, the parent company in my view should hold its corporate interest as a capital asset (see section 4.5.2.2).

No tax consolidation of minority interests; dealing with economic double taxation via other means

It should be noted that in the scenarios in which the interest does not provide the shareholder with a decisive influence on the underlying business affairs, there can necessarily be no economic integration into one economic entity when the firm is regarded as an economic unit and its minority shareholder. Adhering to established commercial accounting practices, the minority shareholder could be accounted technically by means of a full tax consolidation whereby the minority interest appears on the consolidated entity's balance sheet.

Regarding minority shareholder scenarios, the interest does not provide the holder with sufficient economic power to steer the underlying business affairs of its participations. In that case, the aggregate of shareholders and participation is not comparable with a group of affiliated corporate entities or a single entity that operates its business enterprise through one or more branches (or permanent establishments).[629-630] Consequently, the tax consolidation of the aggregate of the shareholder and its non-controlling participation(s) would be incorrect. Regarding proceeds from minority shareholdings, the single taxation of corporate income should be achieved by other means than tax consolidation. This issue is dealt with in Chapter 5 at sections 4.4.3 and 6.4.2.[631]

Necessity of a clearing mechanism

Notably, were the ultimate parent company to be assigned as the (principal) taxpayer for tax assessment purposes and held accordingly liable to pay the corporation tax due, some kind of 'clearing mechanism' should apply so as to secure and facilitate that both the majority and minority shareholder(s) involved effectively contribute to the corporation taxes payable on the underlying business activities of the respective subsidiary company in proportion to their shareholding interest. The mechanism, for instance, would allow the parent company, for instance, to on-charge the corporation tax due to the subsidiary company involved. Clearing payments initiated for this purpose should not attract an additional tax liability.[632] The clearing

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Proposals', 36 *Tax Notes International* 45 (4 October 2004), at 54-55, Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 11-15, and Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 176-178.

[629] Notably, the Court of Justice's comparison between corporate taxpayers with a domestic participation and taxpayers with a foreign participation accordingly is analytically sound in cases where the shareholder does not have a decisive influence in its participation's business affairs. Where the shareholder's interest is held as a capital asset and provides the shareholder with a decisive influence in the underlying business affairs, the comparison between the (foreign) group company and (foreign) branch – i.e., a permanent establishment under the current nexus approach in international taxation – seems the most appropriate. See for a comparison the Opinions of Advocate General Maduro in Court of Justice, cases C-446/03 (*Marks & Spencer II*) and C-168/01 (*Bosal*).

[630] This may also explain why the Court of Justice applies the freedom of capital in scenarios where the shareholder's interest does not provide the shareholder with a definite influence. See, e.g., Court of Justice, case C-446/04 (*FII 1*). For some analytical comparison see Court of Justice, cases C-208/00 (*Überseering*), C-251/98 (*Baars*), and C-284/06 (*Burda*); the latter two notably a contrario. For some further reading and analysis, see Erwin Nijkeuter et al, 'FII 2 and the Applicable Freedoms of Movement in Third Country Situations', 22 *EC Tax Review* 250 (2013), at 250-257.

[631] The argument is made there that this may be achieved by means of an allowance for corporate equity mechanism in conjunction with an 'indirect tax exemption' mechanism at the level of the holder of the corporate interest to eliminate the economic double taxation of the underlying business proceeds derived at the level of the company in which the interest is held. This is further assessed in Chapter 5.

[632] An example may illustrate the operation of such a clearing mechanism. Consider ParentCo holding an 70% shareholding in SubsidiaryCo. ThirdCo holds the remaining 30% of the shares. ParentCo tax consolidates SubsidiaryCo for it having a controlling shareholding interest. The business operations carried on through SubsidiaryCo produce a stand-alone taxable profit of $100. Let us assume that the corporate tax rate equals 20%. ParentCo is liable to pay $20 tax as it constitutes the principal taxpayer for corporate tax assessment purposes. A clearing mechanism applies to ensure that ThirdCo proportionally shares in the corporate tax liability. ParentCo is

mechanism would need to recognize intra-firm transactions to the extent that a minority shareholder is involved.[633]

Worth mentioning is that 50-50 joint ventures would constitute a taxable entity separate from its joint venture partners since the shareholding interests of respective joint venture partners involved would not provide them a controlling shareholding in the underlying firm. That would render the joint venture a separate economic entity and, therefore, a taxable entity separate from the joint venture partners.

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

Decisive influence test is necessary but insufficient

Under the appreciation of the unitary business approach the decisive influence is a necessary condition for identifying the group for corporate tax purposes. But it is an insufficient delimitation criterion as well. The concept of control does address the motive of the parent company involved to pursue or maintain the economic integration of the group of affiliated corporate entities into one economic entity operating the business enterprise.

A decisive influence merely provides for an indication of the parent company's motive. Indeed, the chances are that the definite influence providing corporate interest is held for the purpose of establishing or maintaining the economic integration into a single economic entity. However, this does not necessarily need to be the case. It is conceivable that the shareholder holds its corporate interest with another purpose. The interest may, for example, be held for the purpose of trading it as stock. Or the interest may be held as a portfolio investment.

A motive test is also required

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allowed to on-charge the $20 tax payable to SubsidiaryCo, whose shares in consequence decrease in value with that same amount. The clearance payment does not attract a corporate tax implication. The effect accordingly is that ParentCo's after-tax profit equals $56 (70% * (100 - 20)). ThirdCo's equals $24 (30% * (100 – 20)). The corporate tax liability is accordingly spread among ParentCo en ThirdCo evenly, i.e., in proportion to their shareholding interest.

[633] An example may illustrate the operation of the clearing mechanism in the presence of an inter-company transaction. Consider ParentCo holding a 100% shareholding in Sub1Co and a70% shareholding in Sub2Co. ThirdCo holds the remaining 30% of the shares in Sub2Co. ParentCo tax-consolidates both SubCos for it having controlling shareholding interests in these entities. The business operations carried on through Sub1Co produce a stand-alone taxable profit of $300. The business operations carried on through Sub2Co produce a taxable profit of $700. Let us assume that, in addition, Sub1Co provides a service to Sub2Co worth $60 for which Sub2Co pays Sub1Co a corresponding remuneration. In consequence, Sub1Co's stand-alone profit increases with $60 to $360. Sub2Co's stand-alone profit decreases with $60 to $740. The corporate tax rate equals 20%. ParentCo is liable to pay $200 tax as it constitutes the principal taxpayer for corporate tax assessment purposes. The intra-firm transaction is not recognized for tax purposes as the transaction is eliminated in the tax consolidation process. A clearing mechanism applies to ensure that ThirdCo proportionally shares in the corporate tax liability. The mechanism requires that the internal transaction is recognized for clearing purposes as the service provided by Sub1 Co to Sub2Co indirectly constitutes a service provided by the group to ThirdCo in proportion to its shareholding interest in Sub2Co. The $60 fee paid by Sub2Co to Sub1Co reduces Sub2Co's $700 profit to $640 for clearing purposes. The tax paid by ParentCo attributable to Sub2Co accordingly equals $128 (20% * 700 - 60). The $60 service fee received by Sub1Co from Sub2Co increases its $300 profit for clearing purposes to $360. The tax paid by ParentCo attributable to Sub1Co equals $72 (20% * 300 + 60). ParentCo is allowed to on-charge $128 of its corporate tax payable to Sub2Co, whose shares in consequence decrease in value with that same amount. (ParentCo on-charges $72 of its tax payable to Sub1Co.) The clearance payments do not attract a corporate tax implication. The effect accordingly is that ParentCo's after-tax profit attributable to Sub1Co equals $228 (100% * (300 - 72)). ParentCo's after-tax profit attributable to Sub2Co equals $400.40 (70% * (700 - 128)). ThirdCo's after-tax profit on its investment in Sub2Co equals $171.60 (30% * (700 – 128)). The corporate tax liability is accordingly spread among ParentCo en ThirdCo evenly, i.e., in proportion to their shareholding interest in Sub2Co. Economically, the operation of the clearing mechanism enables ThirdCo to effectively account for its pro rata share in the service fees paid by Sub2Co to Sub1Co for the service rendered (30% * 60 = 18). The recognition of the service fee for clearance purposes translates into a lower amount of corporate tax attributed to Sub2Co which in consequence translates into a proportionally lower reduction in Sub2Co's shareholding value (i.e., relative to the scenario in which no internal transaction would have occurred). Please note that the entering into the $60 service transaction would be driven by market forces as ParentCo and ThirdCo mutually are third-parties.

Accordingly, the motive of the holder of the corporate interest should be taken into consideration when determining the scope of application of the respective tax consolidation regime. This requires an answer to the factual question of the intention of the taxpayer employing the respective interest. The intention of the shareholder may be objectified by means of a functional analysis of the position that the involved property right fulfills in the taxpayer's property.

Motives available: interest held as portfolio investment, trading stock or capital asset

In this respect, one can distinguish between property rights that are held as a current floating asset – i.e., as a portfolio investment, or trading stock – or as a capital asset.[634] One may speak of a:

- portfolio investment in the event that a taxpayer holds a property right for the purpose of earning a yield that may be expected from normal portfolio asset management.[635] In return for a fee, the taxpayer makes its property available for the benefit of the economic activities of another (i.e., third) party;
- trading stock in the event that a taxpayer holds a property right for the purpose of trading it with third parties in return for a selling price;
- capital asset in the event that a taxpayer holds a property right for the purpose of employing it for the benefit of its business enterprise on a continuing basis.

Where property rights are held as trading stock or as a capital asset, the taxpayer involved makes its property available for the benefit of its own business activities.[636] The difference between trading stock and a capital asset is that property held as trading stock lasts for one production process, where property held as a capital asset lasts for multiple production processes.

In the event that the commercially exploited property right is a corporate (shareholding) interest, the aforementioned mutatis mutandis, in my view, holds true as well, since there seems to be no reason to analytically differentiate dependent on the nature of the respective property – i.e., tangible, intangible, or monetary. The nature of the property entitlement involved should not make a difference in qualifying it as a portfolio investment, trading stock, or capital asset.

Tax consolidation allowed only when interest is held for business reasons

Tax consolidation should only be allowed in scenarios where the parent company holds its corporate interest – which grants it decisive influence – for the purpose of employing it for the benefit of the underlying business enterprise on a continuing basis – i.e., the property rights last for more than one production process. The unitary business approach requires that the shareholding interest reflects the integration of the group of affiliate corporate entities into one

[634] See for a comparison Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), distinguishing between active income and passive income at 701 and section iii).

[635] This approach has for example been taken by the Dutch Supreme Court. See Dutch Supreme Court, Hoge Raad, 27 September 1995, No. 30 162, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1996/18, Dutch Supreme Court, Hoge Raad, 23 June 1999, No. 34 570, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1999/294 and Dutch Supreme Court, Hoge Raad, 21 October 2005, No. 40 663, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 2006/126. See also Dutch Supreme Court, Hoge Raad, 7 November 1973, No. 17 182, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1974/2, Dutch Supreme Court, Hoge Raad, 8 November 1989, No. 25 257, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1990/73, Dutch Supreme Court, Hoge Raad, 5 November 1997, No. 32 105 and No. 32 137, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1998/37-38, Dutch Supreme Court, Hoge Raad, 26 August 1998, No. 33 688, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1998/373, Dutch Supreme Court, Hoge Raad, 10 November 1999, No. 34 681, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 2001/140 and Dutch Supreme Court, Hoge Raad, 14 March 2001, No. 36 145, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 2001/210. See for some details and further reading, Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international (*2011), at section 3.

[636] See for a comparison Reuven S. Avi-Yonah, 'The Structure of International Taxation: A Proposal for Simplification', 74 *Texas Law Review* 1301 (1996), at 1305-1310.

economic entity, operating a business enterprise. This requirement in my view is only met in the event that the interest is held as a capital asset. Only then is the corporate interest employed on a continual basis for the benefit of the business enterprise that is operated by the economic entity.

The unitary business approach cannot be reconciled with a consolidation of corporate interests that are held as a portfolio investment or as trading stock. To that extent, there is no presence of a single economic entity operating a business enterprise. With respect to corporate interests held as a portfolio investment or trading stock, the function of the interests as security or merchandise has primary meaning. The underlying property or (business) activities of the corporate entity in which the interest is held is merely of secondary importance to the holder of the interest.

Consequently, the tax consolidation of portfolio or trading stock interests should not be possible. The single taxation of corporate income should then be achieved through alternative means; see Chapter 5 at sections 4.4.3 and 6.4.2. Notably, the nature of the underlying property should not be of pivotal importance to identify the intention (motive) of the taxpayer employing its corporate interest. It merely provides for an indication of the taxpayer's intention as the nature of the underlying property influences the interest's liquidity.

Motive tests in tax consolidation regimes uncommon in the international tax regime

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

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

A side note; full tax liability requirement for tax consolidation rather than motive test in domestic scenario?

Accordingly, one may expect the presence of a motive test in a tax consolidation regime when the risk of losing tax revenue appears for the tax jurisdiction involved. Let us address the matter as a side note to the current analysis.

The risk of losing tax revenue may, for example, appear in a case where a corporate interest is held in an entity that is exempt from corporate tax. Notably, it needs to be said first that there may be a valid reason to exempt (corporate entities conducting) certain activities from corporate taxation. In this respect, one may think of charitable institutions and/or other entities conducting activities that benefit the public without having the objective of yielding a business profit. Such entities may not be taxed on the ground that they do not operate a business enterprise. Moreover, one may think of portfolio investment institutions similarly. Some states, such as the Netherlands, Luxembourg and Ireland, exempt such institutions from corporate tax.[637] Conceptually, there is nothing wrong with that. From a tax perspective, portfolio investment institutions conceptually do not have an independent stance. Investment institution

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

regimes exist solely to meet the societal need for the availability of benefits of scale and the distribution of risks to small-time portfolio investors by means of an intermediary collective investment vehicle. The imposition of a corporate tax at the level of the intermediary would nullify this aim, as the tax cost at the level of the underlying portfolio investor holding its investment through the intermediary would increase in comparison with the tax cost for portfolio investors holding their investments directly. For the purpose of attaining tax neutrality between *directly* held portfolio investments and portfolio investments that are *indirectly* held, i.e., through an intermediary, investment institutions should be considered as 'not present' for corporate tax purposes. Technically, this may be arranged by considering the institution to be transparent ('transparence fiscale'), exempting the taxable entity from tax ('subject exemption'), exempting the proceeds from tax ('base exemption'), or adopting a 0% tax rate. The fund management, of course, would need to be taxed on its profits derived from its fund management services rendered.

Indeed, the adoption of such exemption regimes may result in some perhaps undesired side-effects (arbitrage). The tax consolidation of exempt and taxed entities for corporate tax purposes would entail that taxable profits could be set off against exempt losses with the consequence of the taxable income remaining untaxed. Consequently, the risk of losing tax revenue would become apparent. This may trigger taxpayers to utilize tax avoidance arrangements.

Typically however, rather than applying a motive test, states that have adopted tax exemption regimes commonly counter the aforementioned arbitrage effects by including provisions stipulating that only (fully) taxable entities are eligible to be part of a consolidated tax group. The Netherlands, for example, has adopted such a requirement on the basis of which tax exempt portfolio investment institutions, for example, cannot form a consolidated tax group with regularly taxed entities.[638]

Applying the requirement that exempt entities are not eligible to become part of the consolidated tax group is administratively convenient. Moreover, an interest held in an exempt portfolio investment institution indicates that the holder's intention is to hold the interest as a portfolio investment rather than as a capital asset. Accordingly, the taxpayer's motive appears in an implicit manner.

However, this approach is conceptually unsound as it does not cover all scenarios in which a unitary business is absent. Namely, the adoption of such a requirement entails that corporate entities in which the interest is directly held (i.e., without an investment institution as an intermediary), yet with the intention of holding it as a portfolio investment asset, would become eligible to be part of the consolidated tax group. Substantially, however, a corporate interest does not necessarily have to be held through a portfolio investment institution in order to qualify as a portfolio investment. Corporate interests held as a portfolio investment may very well be held directly rather than through an intermediate portfolio investment institution. Consequently, when interests held as a portfolio investment or trading stock are consolidated, the taxable entity does not correspond with the economic entity. Market distortions may occur as a consequence of this.

My impression is that states take this effect for granted in domestic scenarios, as it does not seem likely that tax revenue will diminish due to this. From the perspective of securing tax revenue, it suffices to adopt a rule providing that exempt entities are not eligible to become part of the consolidated tax group. Yet, the unitary business approach requires that each shareholders interest held as a portfolio investment (or as stock) should be excluded from tax consolidation. Not only when the interest is indirectly held via a portfolio investment institution. Accordingly, only a motive test would provide a conceptually sound outcome in this respect.[639]

[638] See Article 15 Dutch CITA. Under Dutch tax law entities subject to a special tax regime (e.g. exempt from tax, or subject to a 0% tax rate – and with that effectively tax exempt) are ineligible to be part of the consolidated tax group.
[639] Notably, the same would hold true for interests in tax exempt charitable institutions. The tax consolidation of such an interest would be disallowed under a motive test as such an interest would not be held as a capital asset.

Back to the present analysis; tax consolidation is typically unavailable in cross-border environments

Let us return to the current analysis. Furthermore, of relevance for the current analysis is that nation states typically do not allow tax consolidation in cross-border scenarios – see also section 4.4.3. Cross-border tax consolidation is a rare phenomenon in the international tax regime.

If the eligibility to form a consolidated tax group remains limited to (the) domestic (part of) groups, it follows that there is no practical need for introducing a motive test. This is true since no risk of losing tax revenue emerges as the tax consolidation only applies in domestic scenarios. By inference, this perhaps explains the common absence of motive tests in tax consolidation regimes. Notably, the distortive effects of disallowing cross-border tax consolidation are discussed hereunder in section 4.4.3.

Motive tests are common in relation to correction mechanisms that operate across the tax-border

Despite their absence in tax consolidation regimes, motive tests in themselves are not uncommon. They do exist. In practice motive tests are found with respect to the application of the alternative correction mechanisms referred to in the above section 3 of this chapter. Motive tests are made use of in those mechanisms whose scope of application – contrary to tax consolidation regimes – in effect typically does extend beyond the domestic tax borders. And in those cross-border scenarios, the possibility of tax avoidance emerges. In practice, this reality has often been countered by states on the basis of motive tests adopted within the context of their alternative *ad hoc* countermeasures.

In this respect, one may look for the motive tests commonly applied with regard to participation exemption and indirect credit mechanisms, as well as interest deduction limitation and anti-deferral (controlled foreign company or 'CFC') mechanisms. These mechanisms basically seek to:

a) achieve single taxation of active (i.e., business) income in the jurisdiction in which the income has been produced geographically, and;
b) counter the sheltering of passive (i.e., portfolio investment) income in, or the arbitrary shifting of active income to, low-taxing jurisdictions.

To attain these objectives, many states subject the application of these mechanisms to motive tests, amongst others. For example, the Netherlands denies the application of the participation exemption and switches over to an indirect credit mechanism with respect to proceeds from equity interests in (foreign) low-taxed companies that are held as a portfolio investment.[640] Similar 'switch-overs' from exemption to credit can be found in the Austrian and German international tax systems.[641]

Moreover, the various anti-deferral legislations adopting 'look through' or 'deeming dividend receipts' approaches, as a rule, apply in cross-border scenarios. That is, they apply where the controlling corporate interests involved are held in legal entities that are tax-established in low-taxing jurisdictions. Anti-deferral legislation typically applies when these controlling shareholdings are passively held, i.e., to shelter portfolio investment income from taxation.

Anti-deferral regimes can, for example, be found in the tax legislation of the United Kingdom, the United States, Denmark, Finland, Norway, Germany, Italy, Spain, Australia, New Zealand and Japan.[642] Worth noting is that the US anti-deferral regime – i.e., the so-called Subpart F

[640] See Article 13, ninth indent, Dutch CITA. For some details see Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international (*2011), at sections 1 and 3.
[641] See respectively §10(3) Austrian Corporate Tax Code and, e.g., §20 German AStG.
[642] See respectively Chapter IV of Part XVII of the United Kingdom's *Income and Corporation Taxes Act 1988* ('UK ICTA'), Subpart F (Controlled Foreign Corporations) US IRC, §*32* Danish CTA, §1-8 of the Finnish Act on the Taxation of Shareholders in Controlled Foreign Companies (1217/1994), §§10-60 to 10-68 of the Norwegian TA, §§7-

regime, referring to its location in the US tax legislation – under its original proposal in the 1960s addressed both foreign source passive income and foreign source active income. The ratio originally was to uphold the export neutrality underlying the US international tax system regarding foreign source active income derived from foreign subsidiaries as well. However, as such a system would render the competitive position of the US multinationals' overseas investment operations comparatively disadvantageous – i.e., the import neutrality argument – it was decided to limit the scope of the US Subpart F regime's application to foreign source passive income.[643]

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

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

A notable exception: eligibility tests for combined reporting in US state taxation

A notable exception may be found in the experiences in US state income taxation to define the unitary business for the purposes of establishing the eligibility tests for unitary combination.[644] Notably, US state income taxation is extensively addressed in Chapter 6.

For the purpose of drawing a line around the group of affiliated corporate bodies for US state income tax purposes US jurisprudence in this area provides a range of approaches,[645] that is, even though a 'bright line' definition of a unitary business has not been established.[646]

Worth addressing are the concepts of 'three unities' and 'contribution or dependence' that were developed in California. The California Supreme Court articulated its 'three unities of ownership, operation and use test' in *Butler Bros.*: *"[I]t is in our opinion that the unitary nature*

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14 of the German Außensteuergesetz ('German Foreign Transaction Tax Law', or 'German AStG'), Articles 167 and 168 Italian Tax Code, Article 121 Spanish CITA, Part X (Attribution of income in respect of controlled foreign companies) Australian IITA 1936, Subpart EX (Controlled foreign company and foreign investment fund rules) New Zealand ITA and Articles 66-6 to 66-9 Japanese SMTL'. For some reading and analysis of the German regime, see Gerhard Kraft et al, 'The German CFC Rules: Overview, Deficits and Reform Proposals', 42 *Intertax* 334 (2014), at 334-338. Also Brazil has a controlled foreign company regime; for an analysis, see Paulo Rosenblatt, 'Brazil: CFC Rules Update', 40 *Intertax 279 (2012)*, at 279-284.

[643] For some background information and analysis on this matter, see Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000), at 1593 and Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 828.

[644] See for further reading and analyses Charles E. McLure, Jr., 'Defining a Unitary Business: An Economist's View', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 89, at 89-124, Jerome R. Hellerstein, 'Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment', 60 *Tax Notes* 1131 (23 August 1993), at 1136-1145, Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 281-283, Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 243-292, Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 27-32, Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 11-15, and Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 76-82.

[645] The paragraphs until the upcoming header have been drawn from Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 263-266.

[646] See Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 29.

of the appellant's business is definitely established by the presence of the following circumstances: (1) unity of ownership, (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions and (3) unity of use in its centralized executive force and general system of operation."[647] Under the 'contribution and dependence test' which was validated by the California Supreme Court in *Edison Stores,* unity exists *"[i]f the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state ..."*[648]

The US Supreme Court elaborated on the definition of the unitary business for state tax purposes in *Mobil* and *Container*. In *Mobil* the court focused on *"functional integration, centralization of management, and economies of scale"*.[649] In *Container*, the court observed that a flow of goods between the corporate bodies involved is not necessary.[650] Further to the common control, it is the 'flow of value' that counts: *[t]he prerequisite to a constitutionally acceptable finding of unitary business is a flow of value, not a flow of goods."*[651] The approach of the US Supreme Court looking at functional integration, centralization of management, and economies of scale is commonly referred to as the 'modern test'.[652]

Observing US state tax practices McLure and Weiner have suggested to define the unitary business basically by assessing whether there is common control and whether there are substantial amounts of transactions or economic interdependencies within the group: *"[o]ne suggested approach is to ask [a] whether there is common ownership, [b] whether there are significant amounts of transactions or economic interdependence within the group, and [c] whether these could be so important that separate accounting could not be expected to give a reliable result [at least compared with formula apportionment]."*[653]

To my impression, the connecting factors in US state taxation share the purpose of establishing a more or less objective approach to identifying the underlying motive of the firm's management of its controlling interests for active business reasons. That is to optimize profit through functional integration, creating interaffiliate economic interdependencies by engaging in intra-firm transactions thereby benefitting amongst others from economies of scale and scope. Accordingly, the question of whether the controlling interests involved have an active function in the firm's overall business process seems to be of relevance in the end.

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[647] See Supreme Court of California, *Butler Bros. v. McColgan*, 17 Cal. 2d 664 (1941). Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 29 that *"[u]nity of ownership exists if a single taxpayer owns, directly or indirectly, a majority of the voting stock of two or more corporations. Unity of operation arises inter alia from common purchases, centralized advertising and record keeping, common legal representation and intercompany financing. Unity of use is found by not only a flow of goods, but also by shared management and information, common knowledge and expertise, etc."*

[648] See Supreme Court of California, *Edison California Stores v. McColgan* 30 Cal.2d.472 (1947).

[649] See United States Supreme Court, *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S. Ct. 1223 (1980).

[650] It should be noted at this place that Jerome Hellerstein argued 'basic operational interdependence' to constitute a key requirement for defining the unitary business. Such an interdependence would be illustrated by a flow of goods and services between the entities involved. See e.g., Jerome R. Hellerstein, 'Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment', 60 *Tax Notes* 1131 (23 August 1993), at 1143.

[651] See United States Supreme Court, *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983). See also United States Supreme Court, *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 228, at 222-223, 100 S. Ct. at 2109 (1980), *Asarco Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982), *F.W. Woolworth Co. v. Taxation and Revenue Dept. of the State of New Mexico*, 458 U.S. 354 (1982), and *Allied-Signal, Inc. ex rel Bendix Corp. v. Director, Div. of Taxatio*n, 504 U.S. 768 (1992). In *Allied-Signal* the court rejected the use of the state involved of an ownership test on constitutional grounds. This is not further discussed for being a domestic US matter.

[652] See, e.g., Steve Christensen, 'Formulary Apportionment: More Simple – On Balance Better', 28 *Law and Policy in International Business* 1133 (1996-1997), at 1144.

[653] Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 266. See also Charles E. McLure, Jr., 'Defining a Unitary Business: An Economist's View', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 89, 89-124, referring to a three-stage test at 107: *"Test 1: Is there common control? If No: nonunitary. If Yes, then apply Test 2: Are there shared expenses, economies of scale or scope, intragroup transactions, vertical integration, or other economic interdependencies? If No: nonunitary. If Yes, then apply Test 3: Are these substantial? If No; nonunitary. If Yes: Unitary."*

Motive test for tax consolidation to acknowledge the unitary business approach; 'held as capital asset criterion'

The observations in the above seem to basically boil down to the position that a functional criterion should be introduced in the respective tax consolidation regime in order to respect the unitary business approach. This criterion should apply in addition to the decisive influence criterion mentioned in section 4.4.2.1. Notably, this analytically holds up in both purely domestic and cross-border scenarios.

For this purpose of establishing such a functional criterion, one may think of introducing a 'held as capital asset' test in the respective tax consolidation regime of the taxing state. Is the controlling shareholding held as a capital asset, i.e., for business reasons? If yes one would proceed to consolidate the corporate entities involved for taxation purposes. An alternative would be to adopt a 'not held as trading stock' criterion[654] and a 'not held as portfolio investment' criterion.[655] Moreover, such a functional approach may, for example, also be arranged as a tool to distribute the burden of proof between the taxpayer and the tax authorities.[656]

Essentially, such an approach would reflect the notion of the firm deriving its economic rents through its internalization processes. The discovery of these processes for instance by reference to the presence of flows of value, economic interdependencies, and intra-group transactions would accordingly be used to verify the firm management's objective of using its control to conduct an integrated business enterprise. That would subsequently identify the unitary business directing the tax consolidation of affiliate corporate bodies.

Mandatory tax consolidation required to counter arbitrage

In order to avoid arbitrary outcomes or 'cherry-picking' the tax consolidation should apply *in jure* rather than on request. The system would adopt a mandatory 'all-in' approach.[657] The application of the mandatory tax consolidation regime may be attended by a declaratory resolution issued by the respective competent tax authorities (which would be available to litigate through the tax court system). That is for administrative convenience and legal certainty reasons.

Indeed, matters are much similar to the *in jure* grouping of affiliates for value added tax ('VAT') purposes as currently available in the VAT-systems of several of the Member States of the European Union. Known as 'VAT Grouping', *"each Member State may regard as a single taxable person any persons established in the territory of that Member State who, while legally independent, are closely bound to one another by financial, economic and organisational links."*[658] Accordingly, also in European Union value added taxation, the notion of the group as a single taxable entity appears. By treating the group as a single taxable

[654] See for a comparison IFRS 5 ('Non-Current Assets Held For Sale') under which a controlled entity that meets the IFRS 5 criteria as an asset held for sale is separately accounted for under that Standard rather than under IAS 27.
[655] A 'not held as a portfolio investment' criterion has, for example, been reintroduced in the Dutch participation exemption regime as of January 1, 2010, for the purpose of identifying shareholdings held as portfolio investments. See Article 13(9) Dutch CITA.
[656] See for a comparison S.A.W.J. Strik, 'De voorgelegde regeling voor beleggingsdeelnemingen: een verbetering, maar verduidelijking gewenst!', 138 *Weekblad Fiscaal Recht* 969 (2009), at section 5.1.
[657] See for a comparison Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 46, *Progress to date and future plans for the CCCTB,* Taxud E1 TN, CCCTB\WP\046\doc\en, Brussels, 20 November 2006. See for a comparison on the optional CCCTB system also Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 56: *"the Commission proposed making the consolidated base tax system with formulary apportionment optional. Although making the system optional may have many political advantages, it may also introduce some economic disadvantages".* On the allowing of companies to elect the way they are being taxed, Weiner refers to Jack Mintz, 'European Company Tax Reform: Prospects for the Future', 3 *CESifo Forum* 3, (2002), at 3-9, who argues that this *"would substantially erode efficiency gains from harmonization since companies would have greater opportunities to engage in tax arbitrage domestically, not just with respect to cross-border transactions."*
[658] The concept of VAT Grouping is common in European Union value added taxation ('EU-VAT'). The Member States of the European Union may allow affiliates to form a VAT group, thereby creating a single taxable entity disregarding intra-firm transactions for EU-VAT purposes. See Article 11 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added.

entity, European Union value added taxation accordingly appreciates economic reality where the business activities of an aggregate of corporate entities are integrated financially, economically and organizationally into a single economic entity.

Separate accounting where interests are held as trading stock or as a portfolio investment; tax cascading issues to be resolved outside the consolidation system

Excluding tax consolidation with respect to shareholders' interests held as trading stock or as a portfolio investment entails that the separate entity approach would be applied in those circumstances. Market distortions would be the consequence: economic double taxation on similar types of business income (e.g. portfolio investment yields). Value mutations of the underlying property may lead to taxable income at both the level of the corporate entity (taxpayer A) holding the property and the corporate entity (taxpayer B) holding the shareholders' interest, i.e., tax cascading problems.

Solutions for the distortive effects of the separate entity approach with respect to income from shareholders' interests held as stock or as portfolio investments, from my perspective, should nevertheless be sought outside a tax consolidation regime. This issue is addressed in Chapter 5 at sections 4.4.3 and 6.4.2.

4.4.2.3 Equivalent approach to decide on applicable fundamental freedom in primary European Union law?

Perhaps an equivalent approach to decide on which of the fundamental freedoms applies

It is worth mentioning that the adoption of a functional approach through such a 'held as capital asset test' in addition to the aforementioned 'decisive influence test' may also be of some use in answering the question of whether a particular case at hand would fall within the scope of application of the Treaty on Functioning of the European Union. That is, would the case involve a third country scenario.

The relevance of this lies in the legal fact that the confines of European Union law regarding economic operators extend universally where the freedom of capital applies, while its confines are limited to economic operations within the territories of the European Union where the freedom of goods, services and establishment apply. Accordingly, the Member States are required to adhere to European Union law universally when the freedom of capital applies. Notably, the universal application of European Union law under the freedom of capital holds save for the application of the standstill provision and the justification grounds. The standstill provision sanctions distortive tax measures in place as at December 31, 1993. That is, in respect of direct investments; the standstill does not apply to tax measures regarding portfolio investments.

Some certainty as to the applicable freedom in third-country scenarios since FII 2

Since the Court of Justice rendered its decision in *Test Claimants in the FII Group Litigation – FII*, some legal certainty seems to exist as regards applicable treaty freedom in third country situations.[659] In FII 2 the Court of Justice adopts the following approach.

- Tax measures whose subject matter is restricted to majority participations must be assessed as acts of establishment. These are exclusively governed by the freedom of establishment.[660] This could involve regimes dealing with groups of affiliated corporate entities, such as tax grouping regimes or thin capitalization rules.

[659] See Court of Justice, case C-35/11 (*Test Claimants in the FII Group Litigation – FII 2*). For an analysis of the jurisprudence of the Court of Justice involving the deciding on the applicable freedom, see Erwin Nijkeuter et al, 'FII 2 and the Applicable Freedoms of Movement in Third Country Situations', 22 *EC Tax Review* 250 (2013), at 250-257.
[660] See Court of Justice, case C-35/11 (*Test Claimants in the FII Group Litigation – FII 2*), Observation 91.

- Tax measures relating to portfolio investment interests, or measures relating to combating abuse, must be assessed as capital movements or the combating thereof. Such situations are exclusively governed by the free movement of capital.[661] An example is the application of anti-abuse measures in respect of portfolio investments made through subsidiaries/companies in low-taxing jurisdictions, such as controlled foreign company regimes. Another example is the application of regimes that seek to counter dividend stripping operations.
- Tax measures of general application must be assessed in light of the free movement of capital in third country situations.[662] This applies to both minority and majority interests, and irrespective of the active or passive nature of the investment.'[663]

The applicable freedoms of the advocated tax consolidation approach

Transposing to the current analysis, the freedom of establishment would apply exclusively in scenarios where the shareholder has (a) a decisive influence and (b) holds its corporate interest as a capital asset. That is, in the scenarios where the tax system under the advocated approach would proceed to the tax consolidation. In the scenarios where the shareholder would not hold its majority interest with this intention, there would be room for applying the freedom of services – e.g. when the shares are held as trading stock or the freedom of capital – e.g. when the shares are held as a portfolio investment.

Notably, in regards to the latter, i.e., the freedom of capital in passively held majority shareholdings, the standstill provision would possibly not apply. That is, as it only applies to 'direct investments' under the Treaty on Functioning of the European Union. This provision seems to adhere to the commercial definition of 'direct investments' i.e. as distinct from 'portfolio investments'.[664] In line with this interpretation, the limitation of the standstill provision would only apply to investments in shareholdings held as business assets. The standstill provision would then not apply to majority shareholdings held for investment purposes, leading to the traditional distinction – as is also typically recognized in income and capital gains taxation – between passively held portfolio investments and actively held direct investment activities.[665]

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

4.4.3.1 Typically no cross-border tax consolidation is available

As briefly touched upon in section 4.2.2 of this chapter, nation states typically do not allow for cross-border tax consolidation.[666]

There are just a few exceptions. In regards to nation states' international tax systems, to my knowledge, only France ('regime du bénéfice mondial consolidé')[667] and Italy ('consolidato mondiale')[668] allow for full cross-border tax consolidation in some specific circumstances. A

[661] *Ibidem*, Observation 92.
[662] *Ibidem*, Observation 104.
[663] This paragraph has been drawn from Erwin Nijkeuter et al, 'FII 2 and the Applicable Freedoms of Movement in Third Country Situations', 22 *EC Tax Review* 250 (2013), at 250-257 (republication permission co-author granted).
[664] The Court of Justice also seems to make this distinction in its case law, for instance in cases C-282/04 and C-283/04 (*Cie/Nederland*), Observation 19, the joined cases C-437/08 C-436/08 (*Haribo & Salinen*) and case C-194/06 (*Orange Small Cap Fund*).
[665] The analysis in Erwin Nijkeuter et al, 'FII 2 and the Applicable Freedoms of Movement in Third Country Situations', 22 *EC Tax Review* 250 (2013), at 257 concludes as follows: *"It seems that the broader justification grounds in third country situations and, of course, the standstill provision will be given more prominence. As regards the standstill provision, we believe that the shareholder's reason for investing in a shareholding will prove to be relevant. Is the shareholding interest held as a portfolio investment (no standstill) or is it held for business purposes (possibly standstill)? Such a distinction could produce interesting case law. We will follow developments with interest."*
[666] See also Andreas Oestreicher et al, 'How to Reform Taxation of Corporate Groups in Europe', 3 *World Tax Journal* 5 (2011), at 5-38.
[667] See Article 209 quinquies French CGI. France has adopted an optional 'all-in' or 'all-out' approach.
[668] See Articles 130-142 Italian Tax Code. Italy applies an optional 'all-in' or 'all-out' approach as well.

further notable exception can be found in US state income taxation where the practice of combined reporting as a rule extends across US interstate tax-borders, allowing interstate tax grouping within the US Notably, some US states even allow for worldwide combined reporting, a concept known as 'worldwide unitary combination'. That concept allows groups to form a worldwide tax group, accordingly extending the concept of tax grouping across the US nation state's tax-borders also. The concept of unitary combination is extensively discussed in Chapter 6.

To the extent that tax consolidation is made available, nation states typically only allow for such a tax grouping to the extent that the group companies involved qualify as resident taxpayers in the respective taxing state. That is, foreign group companies are generally ineligible to become part of the consolidated tax group. This is, for example, the case in Australia, [669] New Zealand, [670] Japan[671] and the United States[672] (see scenarios 1 to 3 hereunder).

Alternatively, the tax consolidation does apply in regards to foreign tax resident group companies, but only to the extent that:

a) these foreign companies are subject to domestic corporate tax due to the presence of a permanent establishment in the respective tax jurisdiction that is applying the consolidation regime, and;
b) the shareholders' interest in the underlying group company is attributable to that permanent establishment on the basis of a functional and factual analysis.

Examples of the latter approach may be found in the international tax systems of Luxembourg[673] and the Netherlands[674] (see scenarios 4 to 6 hereunder).[675] The Court of Justice shows evidence to support allowance by the Member States to limit the scope of application of their tax grouping regimes regarding foreign tax resident corporate bodies to the business proceeds these derive through permanent establishments situated in the respective territories of the taxing Member State involved.[676]

Notably, this holds up, save for the exceptions of France and Italy which, as previously stated, have adopted optional ('all-in' or 'all-out') worldwide tax consolidation regimes in their international tax systems. However, the formation of cross-border consolidated tax groups under the French and Italian tax consolidation regimes is only possible to the extent that the ultimate parent company is respectively a French or Italian resident taxpayer.[677] France and Italy do not allow non-resident parent companies to be part of the cross-border consolidated tax group.

Under the concept of worldwide unitary combination in US state taxation, the worldwide tax grouping concept extends to both foreign, i.e., out of US nation state subsidiary companies and foreign, i.e., non-US parent companies.[678] The US Supreme Court has constitutionally approved the adoption by the US states of worldwide unitary combination regarding both foreign parents and foreign subsidiaries.[679]

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[669] See Divisions 703 (Consolidated groups and their members) and 719 (MEC groups) Australian IITA.
[670] See Section FM 31 New Zealand ITA.
[671] See Article 4-2 Japanese CTL.
[672] See §1504 (Consolidated Returns) US IRC.
[673] See Article 164bis Luxembourg ITL.
[674] See Article 15 Dutch CITA.
[675] Germany adopts similar requirements re the application of its 'Organschaft' (profit pooling) regime. See §18 German Corporate Tax Code. Accordingly, the German 'Organschaft' does not allow for cross-border profit pooling (contrary to its Austrian counterpart in §9 Austrian Corporate Tax Code).
[676] See Court of Justice case C-337/08 (*X Holding*) and for a comparison case C‑18/11 (*Philips Electronics*).
[677] See respectively Article 209 quinquies French CGI and Articles 130-142 Italian Tax Code.
[678] See for extensive analyses of the concept of Worldwide Unitary Combination Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984).
[679] The US Supreme Court constitutionally sanctioned worldwide unitary combination in *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983). Worldwide unitary combination for US corporations having non-US affiliates (both non-U.S. subsidiaries and non-US parents) has been sanctioned by the US Supreme Court in *Barclays Bank PLC v. Franchise Tax Board of California*, 512 U.S. 298 (1994).

4.4.3.2 Categorizing the ineligibilities to cross-border tax consolidation

Effects when only resident taxpayers are eligible to form a tax consolidated group

Where nation states only allow for the formation of consolidated tax groups to the extent that the string of group companies qualifies as resident taxpayers in the respective taxing state, the following scenarios are unavailable:

1. The tax consolidation of resident taxpayer parent companies with resident taxpayer sub-subsidiaries (group companies) in the event that the intermediate shareholding company has its tax residency outside the respective taxing state's territory;[680]
2. The tax consolidation of same-tier resident taxpayer group companies ('sister companies') in the event that their mutual (ultimate) parent company has its tax residence outside the respective taxing state's territory, and;[681]
3. The tax consolidation of a parent company or subsidiary having its tax residence outside the respective taxing state's territory (foreign group companies).

Effects when only non-resident taxpayers are eligible to form a tax consolidated group, save for the meeting of the permanent establishment threshold

Where nation states enable tax consolidation of foreign group companies, but only to the extent that these companies are subject to corporate tax in the respective tax jurisdiction that is applying the consolidation regime, the following scenarios are unavailable:

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

4.4.3.3 Eligibility depends on tax residence and investment location; differential upon tax-border crossing

Differentials in tax-treatment are based on residence and investment location

[680] The Court of Justice has ruled this limitation to be incompatible with the fundamental freedoms under European Union law in cases falling within the confines of the TFEU; see Court of Justice cases C-39/13 (*SCA Group Holding BV*), C-40/13 (*X AG*), and C-41/13 (*MSA International Holdings BV*). The Court of Justice has ruled such a limitation incompatible with EU law also in analytically similar cases. See Court of Justice, cases C-418/07 (*Papillon*) and C-80/12 (*Felixstowe*). For some further reading and analyses on cross-border tax grouping in EU law, see Bruno da Silva, 'From Marks & Spencer to X Holding: The Future of Cross-Border Group Taxation in the European Union', 39 *Intertax* 257, (2011, No. 5), at 257-265.

[681] *Ibidem*.

In the aforementioned six cross-border scenarios, tax consolidation is not allowed with respect to the group's foreign source business income to the extent that the group of affiliated corporate entities conducts its foreign source business activities abroad through foreign tax resident group companies.

Notably, even Italy and France, which do allow for cross-border consolidated tax grouping, limit the application of their tax consolidation regimes to foreign subsidiaries, rather than also including foreign parent companies. As said, foreign parent companies are ineligible to be part of the French or Italian consolidated tax group. By disallowing the formation of consolidated tax groups in these cross-border scenarios, states do not adopt the unitary business approach with respect to the cross-border (and/or intra-European Union) business activities of groups of affiliated corporate entities. Instead, the separate entity approach is maintained in those cases.

Limitations effectively entail a distortive base exemption of foreign source profit…

Substantially, by disallowing the formation of consolidated cross-border tax groups, the group's foreign source business income is excluded from the domestic corporate tax base substantially through a 'base exemption for foreign income'.[682]

Under a base exemption the market distortions imposed under the separate entity approach are maintained.[683] The aggregation of business losses and profits realized by the respective group companies is not allowed, for example. Cross-border loss offset is unavailable. This results in (liquidity) disadvantages for the internationally active group in comparison with purely domestic scenarios where tax consolidation is possible.[684] See for some comparison the example of *Quincy's Records Company* in Chapter 3 and the analyses in sections 2.4.2, 2.4.4, as well as 4.2 and 5.3.2 of that chapter. Analytically, the effects are the same. A noteworthy exception in this respect is Denmark, whose international tax system (upon request) allows for the pooling of income realized by domestic and foreign group companies (both foreign parents as well as subsidiaries; the all-in approach) under its 'international joint taxation' regime.[685] I understand that a 'claw-back' mechanism applies under the Danish international tax system for the purpose of ensuring single taxation.[686]

In addition to not making cross-border profit pooling available, intra-group transactions are recognized for corporate tax purposes.[687] This, for example, leads to the imposition of exit taxes on cross-border intra-group asset transfers. (Liquidity) disadvantages are the necessary

[682] Corporate entities having their tax residence outside a taxing jurisdiction and without having a permanent establishment situated within that respective taxing jurisdiction's territory are excluded from corporate taxation. Corporate entities having their tax residence outside a taxing jurisdiction, but nevertheless having a permanent establishment situated within that respective taxing jurisdiction's territory are excluded from corporate taxation to the extent that the business income has been earned outside that respective taxing jurisdiction's territory (or, at least, to the extent that the income cannot be attributed to that permanent establishment). That is, a differential in tax treatment solely on the basis of the respective corporate taxpayer's tax place of residence.

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

[684] See also Maarten F. de Wilde, 'Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy', 38 *Intertax* 281 (2010), at section 8 and Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010), at section 3.

[685] See §31A Danish CTA. It should be noted that Austria also allows for cross-border profit pooling under its 'Organschaft' (profit pooling) regime laid down in §9 Austrian Corporate Tax Code. Yet, contrary to its Danish counterpart, cross-border profit pooling is only enabled under the Austrian 'Organschaft' to the extent that it concerns profits realized abroad through foreign subsidiaries (Austria enables an optional profit pooling on a per subsidiary basis). Profits realized abroad by foreign parent companies are excluded from the Austrian profit pooling regime. As with the Danish system, the Austrian regime contains a 'claw-back mechanism' implemented for the purpose of ensuring single taxation: the foreign losses are recaptured if these losses are available to be utilized abroad by way of a local loss carry-back or carry forward.

[686] See §31A Danish CTA.

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

consequence. These effects have already been addressed analytically in sections 3.2.4.2, 3.2.4.4, 3.4.3 and 3.5.3.3 . Again, the issues are analytically identical.

… producing inequities and inefficiencies in the international tax system of the respective state

In the aforementioned six cross-border scenarios, the single taxation of the group's business income is not achieved in an equitable and tax-efficient manner.[688] The limited scope of application of the respective states' tax consolidation regimes in scenarios 1 to 6 entails that multinationals that are economically present within a taxing state and taxed on that basis accordingly are subject to a different corporate tax burden in that state relative to purely domestic scenarios. The different domestic burden imposed is dependent on the question of whether:

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

Despite the reality that groups of affiliated companies operating a business enterprise in today's emerging global market are comparable from a business economics perspective, irrespective of whether the business activities are performed in a cross-border or purely domestic context,[689] they are nevertheless subject to a different domestic corporate tax burden. By doing so, the tax legislation in the respective taxing states distorts the decision of groups of companies as to whether or not to conduct business activities in a cross-border context. Cross-border business activities are made less attractive in comparison with their non-cross-border equivalents. This is unfair. An alternative is therefore required.

4.4.3.4 Fairness requires worldwide cross-border tax-consolidation akin to worldwide unitary combination

Worldwide tax consolidation; treating the multinational firm as a single taxable entity

The concept of fairness in corporate taxation as developed in Chapter 2 calls for consistent adoption of the unitary business approach, and hence allowing for tax-consolidation to appreciate the economic entity to constitute the taxable entity. The concept of fairness within the international tax system of a nation state as developed in Chapter 3 calls for the tax consolidation in both domestic and cross-border scenarios ('worldwide consolidation').

Following precedents in France, Italy and US state income taxation, nation states should enable multinational groups of companies to form cross-border consolidated tax groups. But contrary to the French and Italian regimes that only allow for the consolidation of foreign subsidiaries, tax consolidation should be applied *in jure* with respect to all group companies ('all-in-approach') irrespective of their place of tax residence, i.e., including foreign parent companies. That would accordingly produce an approach conceptually akin to the concept of unitary worldwide combination as traditionally found in US state income taxation.

As argued in section 4.4.2, the tax consolidation of subsidiaries should occur to the extent that the ultimate parent company has a decisive influence on the underlying business activities (see section 4.4.2.1) and holds its corporate interest as a capital asset (see section

[688] Contra Court of Justice, case C-337/08 (*X Holding*). The Court of Justice does not recognize an infringement of the freedom of establishment regarding the Dutch tax consolidation regime not allowing tax consolidation as in scenarios 4 to 6. See Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test',19 *EC Tax Review* 170 (2010).

[689] See for a comparison Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test',19 *EC Tax Review* 170 (2010). Contra Court of Justice, case C-337/08 (*X Holding*) in which the court recognizes a difference in circumstances as a consequence of the differential tax treatment of domestic and cross-border scenarios under the application of the double tax conventions involved.

4.4.2.2). That would effectively entail the treatment for corporate tax purposes of the multinational firm as the taxable entity.

Full pass-through taxation of group companies

The subsidiaries included in the tax consolidation would basically become transparent for corporate tax purposes in a manner comparable to the transparency of disregarded affiliated entities that achieved branch status under the US's 'check the box' regulations. Further, the approach is much like the tax-transparency treatment of partnerships in the international tax regime. The mandatory element in the advocated approach would accordingly render such a full pass-through corporate taxation of both domestic and foreign group companies to become the default approach rather than the exception to the rule.[690]

4.4.3.5 Worldwide taxation in the event of a domestic nexus; double tax relief in the form of a credit for domestic tax attributable to foreign income regarding a foreign nexus

Same approach as advocated in Chapter 3

Adhering to the building blocks for an internally equitable and production factor neutral international tax system as advocated in Chapters 2 and 3, the group would need to be subject to an unlimited corporate tax liability in each tax jurisdiction in which it exceeds a minimum threshold of economic activity. That is, the multinational firm would be fully liable to corporation tax in each jurisdiction in which it operates a business.

The multinational firm's unlimited tax liability within a tax jurisdiction would arise when the taxable entity involved has nexus by conducting a business activity within the territories of the respective tax jurisdiction. The threshold of a minimum economic presence has then been met. Due to the current lack of adequate alternatives to locate the geographic 'source' of business income in practice, the advocated approach would link up with the currently generally applied source concepts like the concept of permanent establishment and the place of effective management.[691] Notably however, the worldwide taxation as advocated in this study is not inextricably linked to the permanent establishment and place of effective management thresholds to establish nexus. Nexus expressions in the international tax regime are discussed as a separate matter in Chapter 6.

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[690] Contra Wolfgang Schön, 'International Tax Coordination for a Second-Best World (Part I)', 1 *World Tax Journal* 67 (2009), at 67 et seq., and Wolfgang Schön, 'International Tax Coordination for a Second-Best World (Part II)', *2 World Tax Journal* 65 (2010), at 68. Schön takes the position that a full pass-through taxation of foreign subsidiaries does not make sense. I respectfully disagree. As a first argument to denounce pass-through taxation, Schön refers to the universal acceptance of the separate entity approach. I however do not see why the separate entity approach would have to be accepted merely because of its current status quo in international taxation. The separate entity approach is just one of the (many) problems in the international tax regime that faces countries attempting to adequately tax multinationals. Referring to its common application in practice for the purpose of denouncing an alternative does not seem to make sense. That is throwing in the towel. As addressed in the introduction to this study legal instruments should not be considered valid or right by simply pointing at their existence. Legal systems including international tax systems are man-made intellectual achievements. They can be shaped, formed and altered to our wishes. If one establishes a rule that does not function properly the response should be to start thinking of an alternative that does work – rather than pointing at the status quo of the flawed rule involved. Moreover, as a second argument, Schön refers to the gap that would otherwise emerge between domestic group companies (taxation on an individual basis) and foreign group companies (pass-through taxation). This gap would become too striking. In my view, the domestic and cross-border scenarios should be tax-treated alike. Provided that this would be achieved no gap would emerge in the first place, as the pass-through taxation mechanism would be applied to both domestic and foreign group companies.

[691] One may also consider in this respect the alternative expressions of the source concepts currently in place in the international tax regime, such as the place where the immovable property is situated, the place where the company paying the dividends has its effective place of management, or the place where the interest and royalties arise. With respect to source taxes levied on portfolio dividend, interest and royalty payments one may think of crediting them against corporate tax levied. These issues however exceed the scope of this chapter and will therefore not be further discussed in detail. Notably, the subject of attributing tax base to taxing jurisdictions (nexus and allocation) is extensively dealt with in Chapter 6.

No differences in tax burden upon tax-border crossing

The ultimate parent company would accordingly be subject to corporate taxation as soon as the group, irrespective of the place of its corporate seat, operates its commercial activities within a tax jurisdiction, e.g., through a fixed place of business or a place of management. As the respective taxing state would subject the parent company to unlimited tax liability it would tax the group on its worldwide business income earned. As a result of this, corporate seats would cease to be of any relevance for the purpose of levying corporate tax. The system would operate devoid of discriminatory obstacles.

To appreciate the sovereignty of states in the field of direct taxation and to acknowledge the single tax principle as well, the adoption of a fair double tax relief mechanism would be required regarding the multinational's foreign business income items. To achieve internal equity and production factor neutrality regarding both cross-border business activities and purely domestic business activities, the double tax relief method would need to be the (per country) 'credit for domestic tax that is attributable to the foreign income' in conjunction with the 'recapture of foreign losses methodology' and the 'carry forward of foreign profits methodology'. That is, the Dutch-style double tax relief method as elaborated upon in Chapter 3. [692]

The application of this double tax relief mechanism as demonstrated in the previous chapter renders irrelevant the question of whether the taxable entity's business income has been generated across various tax jurisdictions. The domestic corporate tax burden imposed would not alter upon a change of tax jurisdiction. Finally, as a complementary measure, withholding taxation on intra-group dividend distributions, as well as intra-group interest and intra-group royalty payments, would need to be abolished as well, i.e., to secure single taxation under the single tax principle.

4.4.3.6 Advocated system in treaty scenarios; administrative assistance called for

The advocated taxing system could be implemented to apply *in jure* in scenarios falling within the scope of application of a nation state's double tax convention network, or within the confines of the Treaty on Functioning of the European Union – the latter regarding intra-European Union investment, that is. In such cases, the advocated approach could be made to apply on the basis of the reciprocity principle. Accordingly, things could apply in a manner similar to that as set forth in section 3.5.5.4.

Similar to the remarks made in section 3.5.5.4, the proper operation of the advocated system would require the implementation of various administrative tools in support of that system. Taxpayers, for instance, would need to be required to provide information on their cross-border business activities. Intensive mutual administrative assistance and cooperation between states would need to be made available. Legal remedies, like international arbitration procedures, would need to be introduced. The presence of accompanying administrative

[692] There is some practical experience with the technical consequences of applying a cross-border tax consolidation, for example in the Netherlands as the former (pre 2003) tax consolidation regime – to a certain extent – allowed for the consolidation of non-Dutch tax resident companies. The consolidation of non-Dutch resident companies was possible, save for meeting the requirement that these companies were incorporated under Dutch company law. In this respect, reference can be made to Dutch Supreme Court, Hoge Raad, 16 March 1994, No. 27 764, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1994/191, Dutch Supreme Court, 29 June 1988, No. 24 738, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1988/331, Dutch Supreme Court, Hoge Raad, 13 November 1996, No 31 008, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1998/47, and Dutch Supreme Court, Hoge Raad, 3 February 2012, No 10/05383, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 2012/126. Possible technical double-tax treaty complications of cross-border tax consolidation are left out of consideration. See on this matter Frank P.G. Pötgens et al, 'Cross-border Fiscal Unities and Tax Treaties: Nothing New under the Sun?', 42 *Intertax* 92 (2014), at 92-105, and C. van Raad, 'Internationale aspecten van het herziene regime inzake de fiscale eenheid', 129 *Weekblad Fiscaal Recht* 85 (2000). For some analysis in conceptually equivalent matters – i.e., re the compatibility of CFC regulations with double tax conventions – see Michael Lang, 'CFC Regulations and Double Taxation Treaties', 57 *Bulletin for International Taxation* 51 (2003), at 51-58. Note that double tax treaty implications should be irrelevant in scenarios falling within the scope of application of the Treaty on Functioning of the European Union. The reason for this is that the international tax systems of the European Union Member States (i.e. both their domestic tax legislation and their double tax treaty network) are subordinate to supranational European Union law.

mechanisms would be of significant importance. These provisions would need to be made available in the respective states' international tax systems. One may think of the administrative provisions in domestic legislations and double tax convention networks involved, as well as the Mutual Assistance Directive and Arbitration Convention in a European Union context.

Indeed, this may lead to administrative difficulties. However, practical challenges should not necessarily be insurmountable. At the end of the day, it is the required willingness of nation states to assist each other administratively that may prove to be the bottleneck for a the approach to function properly, as advocated in the above. In the event that a system adhering to the advocated approach would lead to practical problems in assessing the corporate tax – e.g. if practice would show that the relevant information for determining the taxpayer's tax position is not made available – the solution to that problem would need to be sought by improving international administrative assistance. And as mentioned already in section 3.5.5.4, the recent developments in 'country-by-country reporting' show evidence of a trend towards an international consensus on the need for global transparency in tax administrative matters.

Moreover, the potential for administrative problems would not render the advocated approach analytically invalid. Indeed, the Court of Justice, for instance, does not recognize administrative difficulties, such as a lack of information on the foreign income of taxpayers, as grounds to justify obstacles imposed by European Union Member States regarding intra-European Union economic activity.[693] In these cases the court consistently rejects this argument by pointing out that relevant information can be obtained on the basis of the Mutual Assistance Directive, for instance.

4.4.3.7 Switch-over to credit mechanism to counter potential for tax-abuse

The possibility under the advocated approach of an allowance for a sheltering of passive income in a foreign low-tax jurisdiction may be countered by making use of a switch-over mechanism to the credit method.[694] To tackle the potential for tax abuse beforehand, the relief system would switch-over to the commonly applied credit for foreign tax method, rather than operate the Dutch-style double tax relief mechanism advocated, which I elaborated on in the above. The switch-over would accordingly be based on anti-tax abuse considerations.[695] The mechanism could operate as an indirect credit mechanism, e.g., by reference to a typical look-through approach taxing the sheltered passive investments directly, or by reference to a mark-to-market valuation of the shareholding interests held in the legal entities involved in which the portfolio investments are sheltered.[696]

The switch-over could be made available in cases where neither a double tax convention nor the Treaty on Functioning of the European Union applies. The switch-over could apply on the basis of a motive test. Inspiration for designing such a motive test can be found in the jurisprudence of the Court of Justice as developed in its Cadbury Schweppes and Part Service rulings.[697] In that event, the switch-over to the direct credit mechanism would apply regarding artificial arrangements lacking economic substance set up with the intention of escaping the domestic corporate tax normally payable.[698] The switch-over could be combined

[693] See e.g. Court of Justice, cases C-101/05 (*Swedish A*) and C-446/04 (*FII*), as well as (joined) cases C-437/08 and C-436/08 (*Haribo & Salinen*), and C‑72/09 (*Rimbaud*).
[694] See on anti-abuse rules generally and particularly in respect of the anti-abuse clause in the European Commission' s CCCTB proposal, Peter Harris, 'The CCCTB GAAR: A Toothless Tiger or Russian Roulette?', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012), at 271-297.
[695] Cf. Court of Justice, case C-196/04 (*Cadbury Schweppes*). Contra Court of Justice, case C-403/03 (*Egon Schempp*).
[696] The latter approach e.g., is adopted in the Netherlands international tax system; see Article 13a Dutch CITA.
[697] See Court of Justice, cases C-196/04 (*Cadbury*) and C-425/06 (*Part Service*).
[698] See on anti-abuse rules generally, and particularly re the anti-abuse clause in the European Commission' s CCCTB proposal, Peter Harris, 'The CCCTB GAAR: A Toothless Tiger or Russian Roulette?', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012), at 271-297.

with a 'subject to a reasonable tax clause'.[699] Were the taxpayer involved to demonstrate that its passive income abroad is subject to a reasonable tax, the switch-over would not kick in. That is, as in such a case it may be considered verified that the motive for dodging corporation tax liabilities would be absent.

Adhering to the principle of administrative convenience, the switch-over mechanism could be combined with a rule placing the burden of proof, i.e., the burden of providing conclusive evidence in support of the position of not engaging into a tax sheltering, at the level of the taxpayer invoking the double tax relief. The merits of introducing a switch-over mechanism to tackle potential abuse under the approach as advocated up until this point in the current analysis is not further discussed, as this study, in the end, advocates a destination basis profit allocation mechanism. That would resolve the tax sheltering issue conceptually via an alternative means.[700]

4.5 Consequences

4.5.1 Weighing the pros and cons: the pros

4.5.1.1 The system would enhance fairness

The system would be fair as the tax burden of multinational firms would be indifferent to legal organization, tax residence and investment direction

The unlimited corporate tax liability of multinational firms that are economically present within the respective tax jurisdiction in conjunction with a 'credit for domestic tax that is attributable to the foreign income' would entail fairness within the corporate tax system of a state. The tax treatment of firms would be brought up to the exact same level in both cross-border and non-cross-border (i.e., purely domestic) scenarios.

The intra-firm legal organization of business affairs would become immaterial for corporate tax calculation purposes. Such an approach would remove all distortions that are currently caused by the commonly adopted approach of treating each group company as a single taxable entity for corporate tax purposes. Also the residency of the taxable entity would be rendered immaterial for tax purposes. Corporate tax burden and revenue levels would not be influenced by the multinationals' legal structuring or the question of whether business is conducted in a domestic or cross-border context. It would fully appreciate the neutrality of the legal form. This perhaps requires some clarification.

4.5.1.2 The system would be obstacle-free

First, an international tax system as proposed would not lead to any obstacles imposed with respect to the corporate taxation of multinationals as addressed in the first and third chapter of this study.[701] The domestic corporate tax levied on the group's business income would be the same under all circumstances. It would promote internal equity and production factor neutrality.

The advocated approach would resolve the following current issues in the international tax regime:

[699] See for a comparison Vogel's remarks on introducing a subject to tax clause in Klaus Vogel, 'Which Method Should the European Community Adopt for the Avoidance of Double Taxation?', 56 *Bulletin for International Taxation* 4 (2002), at 6.
[700] Notably, under the CFC-rules in the Commission's Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS), no credit is granted for the tax paid by the controlled foreign company. Under the advocated approach an indirect credit would become available, though.
[701] See for a comparison Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010), at 170-182, at section 7.

- The corporate seat of the group would not entail any differences in corporate tax treatment. Therefore, discrimination issues would not arise; see section 5.3 of Chapter 3 for some comparison;
- It would not make any difference whether the group realizes its business profits solely within one tax jurisdiction or spread across various tax jurisdictions. The way in which the production factor movements are directed – i.e., inward bound or outward bound – would have no influence whatsoever on the tax burden in the respective taxing state. Jurisdiction entry and jurisdiction exit restriction issues would accordingly not arise; see section 5.3.1 of Chapter 3 for some comparison;
- The aggregation of losses and profits realized by the various (foreign) affiliates of the same group within the tax year would be enabled – i.e., cross-border horizontal loss compensation. Liquidity disadvantages would not arise since the legal transactions between the affiliates would be treated for corporate tax purposes on par with the economically equivalent internal dealings between the branches of a single entity, i.e., tax parity of intra-firm inter-entity transactions and intra-firm intra-entity dealings; see section 5.3.2 of Chapter 3 for some comparison;
- Intra-firm cross-border asset movements would not lead to the immediate imposition of exit taxes on hidden reserves. Foreign source income items would be kept outside the domestic tax base both in an effective and economically efficient manner; see section 5.3.3 of Chapter 3 for some comparison;
- In scenarios falling within the scope of the Treaty on Functioning of the European Union, such an international tax system would be in full compliance with the freedom of establishment; see section 6.1 of Chapter 3 for some comparison.
- The unlimited corporate tax liability for groups in conjunction with a 'credit for domestic tax that is attributable to the foreign income' would have consistently resolved the conceptual challenges that the Court of Justice was faced with in, for example, the Futura and X Holding cases; see section 6.2 of Chapter 3 for some comparison.[702]

4.5.1.3 The system would operate invariantly regarding the legal organization of the firm; no paper profit shifting incentives through intra-firm legal structuring

Second, under the advocated approach, the legal structuring of the business activities of the group would cease to have any influence on the territorial allocation of the group's business profits. Under all circumstances, the profit allocation would take place on the basis of the two-step analysis as developed by the OECD with respect to the allocation of profits realized through permanent establishments. Notably, profit allocation, as stated above, is addressed as a separate issue in Chapter 6.

The neutralization of legal realities within the group of affiliated corporate entities would entail that the distortions caused by the separate entity approach would dissolve. Hence, the treating of the group as the taxable entity for corporate tax purposes would render the adoption of the *ad hoc* measures or 'halfway solutions' mentioned in the above section 3.1.4 of this chapter superfluous. Specifically, one may think of measures countering the distortive effects that are caused by:

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

[702] See Court of Justice, cases C-250/95 (*Futura*) and C-337/08 (*X Holding*). Contra, Court of Justice, case C-527/06 (*Renneberg*). For a discussion of this case law, see Chapter 3 of this study, as well as Maarten F. de Wilde, 'Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy', 38 *Intertax* 281 (2010), at section 8 and 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, at sections 2 to 5.

Ad. 1. Neutralizing arbitrage involving intra-firm financing arrangements

The unlimited tax liability of groups in conjunction with a credit for domestic tax attributable to foreign income would entail that all intra-group financing arrangements would be disregarded for the purpose of levying corporate tax. Accordingly, the current arbitrary differences in corporate tax treatment between intra-firm debt and equity financing transactions would be resolved as the corporate tax treatment of such arrangements would be identical (i.e., non-existent for corporate tax purposes).

Traditionally, internal debt financing arrangements within a single corporate entity, i.e., between a permanent establishment and its head office, is not recognized for the purpose of allocating corporate profits to tax jurisdictions. Notional interest between a permanent establishment and its head office is non-deductible and non-taxable. An impairment of notional debt receivables is impossible. With regards to notional debt financing arrangements, this is, for example, current international tax law in the Netherlands.[703] To my knowledge, the same holds true in many international tax systems with respect to internal equity financing. A notional shareholding between the head office and its permanent establishment is not recognized for corporate tax purposes.

Non-recognition of intra-firm financing makes economic sense

In my view, such an approach makes sense economically. Internal financing arrangements between the head office and a permanent establishment do not affect the overall business profit realized by the respective taxpayer.[704] No value has been added at the level of the multinational firm involved. Accordingly, there is no economic reality that could support the recognition of notional interest payments or notional dividend distributions (or 'branch remittances') for corporate tax purposes.

Cross-border tax consolidation, in a manner as advocated in the above, would widen the scope of the traditional approach in which internal financing arrangements are not recognized for corporate tax purposes by intra-group financing arrangements. In my view, that would be the favorable approach.

It can be said that intra-group debt and equity financing arrangements, substantively, do not lead to value mutations in the capital of the group, the economic entity.[705] From a business economics perspective, intra-group dividend distributions or interest payments do not lead to value mutations for the group as a whole (this only holds true with respect to financing arrangements between third parties). It conflicts with economic reality to recognize intra-group financing arrangements for corporate tax purposes (e.g. allowing a deduction for intra-group interest payments as is the case under virtually all international tax systems currently in place throughout the world).

OECD steps toward recognition of intra-firm financing in 2010; steps in the wrong direction

For the same reason, I do not believe that the trend launched by the OECD with its 2010 amendments to its Commentary on the OECD Model Tax Convention to widen the scope of application of the functionally separate entity approach to notional debt financing arrangements between permanent establishments and their head offices is recommendable.[706] Doing so would only offer a tool for multinationals to shift their business

[703] See Dutch Supreme Court, Hoge Raad, 7 May 1997, No. 30 294 and No. 31 795, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1997/263-264, as well as Dutch Supreme Court, Hoge Raad, 25 November 2005, No. 40 858, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 2007/117.
[704] See for a comparison Eric C.C.M. Kemmeren, 'Vermogensetikettering bij een vaste inrichting (deel 2)', 132 *Weekblad Fiscaal Recht* 2005 (2003), at section 4.2.2.
[705] Notably, the same in my view is true with respect to other intra-group services rendered and goods supplied. Also these essentially do not add economic value to the firm.
[706] See OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

profits to low-taxing jurisdictions through intra-firm notional debt financing dealings. It would introduce the same problems that international tax systems are currently facing when seeking to tax the proceeds from intra-group financing arrangements.

The consequence would be the necessity felt to implement specific measures, such as notional interest deduction limitations, notional thin capitalization rules, or notional earnings and stripping regimes, to counter the subsequent distortion caused by the extension of the functionally separate entity approach to notional debt financing dealings. This is the case with respect to intra-group debt financing arrangements in most international tax systems in place today.

Cross-border tax consolidation instead

I would therefore choose another course. Derecognizing intra-group debt and equity financing arrangements for corporate tax purposes in accordance with economic reality is achieved with cross-border tax consolidation (provided that the traditional approach with respect to permanent establishments and their head offices is being maintained). Accordingly, participation exemption or indirect credit mechanisms with respect to (cross-border) intra-group proceeds on equity interests for the purpose of mitigating economic double taxation (paraphrased as 'equity interest box regimes') would become superfluous. There would be no need for such correction mechanisms as there would be no distortions that would need to be countered in the first place.

Notably, from this perspective, the solution that has received heavy criticism internationally, the 'halfway' solution that had been proposed by The Netherlands in 2009 mentioned in the above to introduce a mandatory group interest box – i.e., an exemption for intra-group interest payments for corporate tax purposes – conceptually would have been a step in the right direction rather than the adoption of a harmful tax measure as had been argued by some commentators.[707-708] From that perspective, it may be considered unfortunate that the proposal has been withdrawn before it ever saw the light of day.

There is nothing wrong with a derecognition of intra-group debt financing arrangements for corporate tax purposes, simply because no value has been added when one considers things from the perspective of the economic entity, i.e., the group as a whole. Accordingly, the conceptual problem does not lie at the level of the state not taxing the intra-group interest proceed. The conceptual problem lies at the level of the state that allows for the tax deduction of the intra-group interest payments, as this is not in accordance with business economics realities. The jurisdiction from which the intra-group interest has been paid gives rise to problems (disparities) by allowing a tax deduction with respect to economically non-existent debt interests. Consequently, as the non-taxation of intra-group debt proceeds concurs with economic reality (the unitary business approach), regimes exempting intra-firm debt proceeds should not be regarded as illegal state aid or (harmful) tax competition.

Nevertheless I favor tax consolidation over a group interest exemption regime as tax consolidation would entail the derecognition of intra-group debt financing arrangements *in jure*, rather than on the basis of an *ad hoc* countermeasure such as a specific exemption regime. Accordingly, in that event, the need to introduce a group interest exemption regime by way of analogy to a group equity interest exemption regime would become obsolete – i.e., a participation exemption or 'equity interest box'.

[707] See for a comparison Rita Szudoczky et al, 'Revisiting the Dutch Interest Box under the EU State Aid Rules and the Code of Conduct: When a 'Disparity' Is Selective and Harmful', 38 *Intertax* 260 (2010), at 260-280.
[708] See for a comparison the proposals by F.A. Engelen et al, 'Wijziging van belastingwetten met het oog op het tegengaan van uitholling van de belastinggrondslag en het verbeteren van het fiscale vestigingsklimaat', 137 *Weekblad Fiscaal Recht* 891 (2008), and F.A. Engelen et al, 'Eenvoud, evenwicht en een lager tarief vennootschapsbelasting',138 *Weekblad Fiscaal Recht* 953 (2009) to introduce a 100% exemption re intra-group debt proceeds. See also the Letter of the Dutch State Secretary for Finance to Parliament of 15 June 2009, DB/2009/227U in which the State Secretary for Finance introduced a mandatory group interest box regime. It should be mentioned that the Dutch State Secretary for Finance proposed an 80% exemption, rather than a full exemption as was originally suggested by Engelen et al.

System reform as advocated would render the need for interest deduction limitations obsolete

In addition to this, derecognizing intra-group financing arrangements with a system reform in a manner as described above would also entail that the issues with respect to refinancing arrangements within the group – i.e., the transformation of intra-group debt capital into intra-group equity capital and/or vice versa – for the purpose of benefiting from the differences in the corporate tax treatment of such financing arrangements would become a relic of the past as well.

Today, tax systems that provide for a participation exemption or indirect credit mechanism intrinsically allow for the possibility to impair an intra-group debt receivable for corporate tax purposes (and consequently to suffer a tax loss). Subsequently, they convert the impaired debt receivable into a corporate shareholding to benefit from a following tax-exempt or creditable increase of the shareholding's worth under the participation exemption or indirect credit mechanisms. In such a case, the deductible tax loss is not compensated with a corresponding taxable profit. Some states, such as the Netherlands, have adopted technically complex measures to counter this undesired effect (no exemption / credit to the extent that the loss has not been recaptured).[709]

Moreover, various international tax systems which distinguish between intra-group debt and equity financing arrangements intrinsically enable the possibility to finance equity capital payments with debt capital (e.g. a corporate entity lends sums of money from its affiliate to finance a dividend distribution or an equity contribution). By doing this, non-tax-deductible intra-group equity capital payments (e.g. dividends, equity contributions) may be arbitrarily converted into tax-deductible intra-group debt capital payments (interest). The Netherlands, again for example, and arguably many other states have adopted specific anti-abuse measures (interest deduction limitations) for the purpose of countering such possibilities.[710]

The abolishment of the recognition of intra-group financing arrangements would eliminate the advantage of employing such arrangements for the purpose of reducing the corporate tax base. Accordingly, intra-group refinancing arrangements would cease to have any effect with respect to the levying of corporate tax within a given tax jurisdiction. As a result of this, the various countermeasures as commonly adopted by states to counteract these refinancing arrangements would become obsolete.

Ad 2. Neutralizing arbitrage involving branch versus subsidiary differentials

With an unlimited tax liability for groups and the tax exemption as a double tax relief method, the sense of specific correction mechanisms aimed at countering the distortive effects that result from the arbitrary differences in corporate tax treatment between the incomes realized from businesses operated through branches and those of group companies would disappear. That would dissolve the arbitrage involving branch structure versus subsidiary structure decisions.

The transparency of group companies that result from applying the tax consolidation would make such countermeasures superfluous as the legal structuring of the business activities of the group would no longer influence the corporate tax liability. The aggregation of current business losses and profits, for example, would apply *in jure*. Single taxation is achieved in a cross-border context by applying the Dutch-style double tax relief methodology.

System reform as advocated would render the need for profit pooling regimes obsolete

There would be no need for specific profit pooling regimes as currently in place in Germany and Austria ('Organschaft'), the United Kingdom and Ireland ('group relief regime'), Portugal ('Regime Especial de Tributação dos Grupos de Sociedades'), Denmark ('national' and

[709] See Article 13ba Dutch CITA.
[710] See Article 10a Dutch CITA.

'international joint taxation regime'), Norway and Finland ('group contribution regime').[711] Or, alternatively, the relevance for regimes enabling tax-deductible impairments of equity interests in foreign loss-making group companies (Spain), or liquidation losses set-off regimes (the Netherlands),[712] would become obsolete as well. In addition to this, intra-group transactions would be dealt with in a tax efficient manner. In a domestic context, intra-group transactions would not be recognized for corporate tax purposes.

> System reform as advocated would render the need for intra-firm asset transfer regimes and intra-firm mergers and acquisitions regimes obsolete

In a cross-border context, the application of the separate entity approach would not entail any distortions due to the application of the advocated double tax relief mechanism.[713] Accordingly, there would be no need for regimes enabling tax efficient intra-group mergers and acquisitions as intra-group reorganizations would not trigger an immediate corporate tax liability in the first place.

Moreover, the same is true for regimes enabling tax-neutral intra-group asset transfers, such as, for example, those currently in place in the United Kingdom and Ireland ('capital gains tax group relief').[714] In addition, it would, for instance, render redundant regimes seeking to counter the availability under the separate entity approach of so-called 'repackaged asset transfer transactions'. That is, the tax-induced engaging into transactions whereby instead of transferring the asset to a third-party buyer – which would trigger a corporate tax liability – the assets involved are first transferred tax-free within the firm to a tax consolidated subsidiary, i.e., to subsequently dispose of the shares without taxation under the application of an economic double tax relief mechanism such as a participation exemption regime. Under the advocated system, the disposal of the shares shall imply the disposal of the underlying assets triggering the liability for corporate tax purposes.[715] The subsidiary company involved would remain tax transparent until the third-party asset disposal.

> *Ad. 3. Neutralizing arbitrage involving the financing of the business operations undertaken through controlled non-tax consolidated foreign subsidiary companies*

The recognition of the group as a single taxable entity would solve the issues which arise from the application of a gross-based participation exemption or indirect credit mechanism to proceeds from foreign controlled non-consolidated subsidiaries in combination with the territorial allocation of costs relating to the financing of the shareholdings in these subsidiaries.

> Territorial mismatch in taxing business profit and deducting related financing expenses

The application of a participation exemption or indirect credit mechanism in an international tax system typically has the following intrinsic consequence. On the one hand, an exemption or credit is granted at the level of the corporate shareholder with respect to proceeds from foreign subsidiaries. As the subsidiary's business profits are taxed abroad, economic double taxation at the level of the shareholder is mitigated on the basis of an economic double tax relief mechanism (exemption or indirect credit). On the other hand, the expenses that have been incurred relating to the financing of the shareholdings in these subsidiaries are nevertheless typically considered to constitute tax deductible items at the level of the corporate shareholder.

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[711] See respectively §§14-19 German Corporate Tax Code, § 9 Austrian Corporate Tax Code, Part 5 UK CTA, Section 420 Irish TCA, Articles 69-71 Portuguese IRC, §§31 and 31A Danish CTA, §§ 10-2 to 10-4 Norwegian TA and Articles 1-8 Finnish KonsAvL.
[712] See Article 13d Dutch CITA.
[713] See Maarten F. de Wilde, 'Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy', 38 *Intertax* 281 (2010), at section 7 and Maarten F. de Wilde, 'On X Holding and the ECJ's Ambiguous Approach towards the Proportionality Test', 19 *EC Tax Review* 170 (2010), at section 3.
[714] See Section 171 UK TCGA and Section 617 Irish TCA.
[715] Accordingly, an anti-abuse mechanism such as Article 75 Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS) would be unnecessary.

As a consequence, a jurisdictional mismatch occurs between the taxable business profits realized – i.e., at the level of the subsidiary in the tax jurisdiction of source – and the tax deductible costs incurred with respect to the financing of these foreign source business activities – i.e., at the level of the corporate shareholder in the taxing jurisdiction of origin. Such a mismatch, for instance, also exists in the European Commission's CCCTB Proposal. The proposal shows evidence of embracing a gross-based exemption regarding shareholding proceeds, while allowing the taxpayers involved to deduct related financing expenses from the tax base.[716]

Nation states seek to resolve this loophole typically with deduction limitations for interest payments on intra-group (or sometimes even third party)[717] debt financing arrangements. For this purpose, one may think of the countermeasures commonly referred to in international tax practice as thin capitalization measures. These are, for instance, in place in Denmark, France, Spain, Australia, New Zealand and Japan.[718] One may also think of 'earnings stripping rules' as in place in Germany, Italy and the United States.[719] Notably, a targeted interest deduction limitation that specifically seeks to strike down the arbitrage at this point can be found in the Dutch international tax regime.[720] In place as of 2013, the measure conceptually lies somewhere in-between a thin capitalization measure and an earnings and stripping measure. This is not further discussed.

Mismatch would dissolve under the advocated approach; *in jure* debt-push down

With the unlimited tax liability for groups in conjunction with a credit for domestic tax attributable to foreign income, the financing costs with respect to externally attracted debt capital would be allocated for corporate tax purposes to the geographic location where the group's business activities are actually performed. Such an approach would basically entail an automatic 'debt push down' for corporate tax purposes. As the issue referred to in the above paragraphs would not arise under the approach advocated in the first place, it follows that there would be no need for interest deduction limitations to resolve it.

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[716] See Article 11(c) and (d) in conjunction with Article 14 (1)(g) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). Notably, European Commission, Common Consolidated Corporate Tax Base Working group (CCCTB WG) Working Paper No. 57, *CCCTB: possible elements of a technical outline,* Taxud E1, CCCTB/WP057\doc\en, Brussels, 26 July 2007, at 9 (footnote 13) considers financing expenses not to qualify as *"costs incurred for the purpose of deriving income which is exempt pursuant to Article 11…"*

[717] The application of interest deduction limitations re third party debt arrangements cannot be justified analytically. No conceptual objection exists to grant a tax deduction for external interest expenses. Interest payments to third parties are actual financing expenses. Under an income tax these items should be deductible as a consequence.

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

[719] See respectively §4h German Income Tax Code, Article 96 Italian Tax Code and §163(j) (Limitation on deduction for interest on certain indebtedness) US IRC. Notably, it has recently been proposed to expand the US interest deduction limitation, see U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, March 2014, at 49-50. The proposal basically seeks to limit a group member company's deductible US interest expense to an amount equal to that member's proportionate share in the overall third-party interest paid by the consolidated group to which it belongs (i.e., the consolidated group for accounting purposes under e.g. US GAAP or IFRS; foreign controlled subsidiaries are included for the purpose of calculating that proportionate share). That amount would be increased with an amount equal to the respective member's interest income. *"A member's proportionate share of the financial reporting group's net interest expense would be determined based on the member's proportionate share of the group's earnings (computed by adding back net interest expense, taxes, depreciation, and amortization) reflected in the group's financial statements."* A numerical example may illustrate the operation of such an interest deduction limitation. Let us assume that US Group Corp. pays $100 interest, e.g., to an intra-firm creditor overseas. It is further assumed that the group's net third-party interest expense would equal $150 and that US Group Corp.'s share in the group's EBITDA would equal 30%. In that event, save for the application of other deduction limitations, the amount of tax-deductible interest would equal $45 – i.e., US Group Corp.'s 30% share in the group's net interest expense (0.30 * 150 = 45). The deduction limitation at the level of US Group Corp. would accordingly equal $55 (100 - 45). If US Group Corp would have received $20 stand-alone interest income, ceteris paribus, the tax-deductible amount would equal $65, i.e., the $20 stand-alone interest income added with $45 – i.e., US Group Corp.'s 30% share in the group's net interest expense. The deduction limitation at the level of US Group Corp. would accordingly equal $35 (100 - 65). Non-deductible interest would be carried forward infinitely.

[720] Article 13L Dutch CITA.

The recognition of the group as a single taxable entity would require that interest paid to third parties would be attributed to the geographic location where the group operates its financed business activities on the basis of a functional and factual analysis – such is currently already the case with permanent establishments. Consequently, such a 'branching' of the group companies involved, piercing the corporate veils for corporation tax purposes would entail a consistent functional allocation of external debt interest expenses to the taxing jurisdiction in which the financed business activities are actually performed.

The allocation of third-party financing would accordingly take place irrespective of the legal form chosen by the economic operator in arranging its business affairs.[721] This approach would *in jure* resolve the aforementioned jurisdictional mismatch between the taxable business profits realized and the deductible costs incurred with respect to the financing of these respective business activities. Local business activities would be taxed at the net amount. Double tax relief regarding the proceeds from foreign business activities would be granted at the net amount as well. Notably, the effects as regards the financing of third-party shareholdings are addressed in Chapter 5 at sections 4.4.3 and 6.4.2.

Thin cap issues would be resolved

It would follow that there would no longer be any tax incentive in place for thinly capitalizing group companies through intra-group financing arrangements issued for the purpose of reducing the corporate tax base. The tax-treating of the group as a single taxable entity for corporate tax purposes would entail that the debt to equity ratio of the group for corporate tax purposes would correspond to the commercial debt to equity ratio of this group. Intra-group financing arrangements would not be recognized; only third party debt arrangements would. Consequently, any need for interest deduction limitations – such as a thin capitalization or an earnings stripping rule – would then become redundant.[722]

No incentive for tax-induced engaging into 'flow-through' and treasury activities

Moreover, the advocated approach would bring about an equitable and neutral corporate taxation of intermediate shareholders' activities, as well as 'flow-through' and treasury activities. The taxable 'spreads' with respect to the rendering of administrative 'shareholders' services, 'flow-through services' and 'group financing services', that are commonly taken into consideration on the basis of a functional and factual analysis and the arm's length principle would remain untouched. That is, as there would be no differential in treatment regarding undertaking activities through branches relative to group companies. For example, the economic function of treasury activities performed – i.e., apportioning the group's debt and equity capital attracted from third parties to the various business activities of the group – would be awarded with an at arm's length consideration in accordance with currently applied transfer pricing concepts and would be taxed accordingly.

[721] See for a comparison Court of Justice, case C-168/01 (*Bosal*). As from the Court of Justice's Bosal ruling, it is possible in the Netherlands to deduct financing costs relating to foreign business activities from the Dutch corporate tax base, yet receiving the proceeds from such foreign operations on a tax-exempt basis under the participation exemption. The unlimited corporate tax liability of groups with a tax exemption for foreign business income would automatically close the loophole in the Dutch international tax system that emerged subsequent to the Bosal ruling (commonly referred to in the Netherlands as the 'Bosalgat', in English: 'Bosal Loophole'). That would render the need for the current Article 13L Dutch CITA redundant. For a similar observation see the concluding remarks in Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013).

[722] It also would not, for instance, be necessary to adopt an interest deduction limitation by reference to the group's worldwide debt to equity ratio, as suggested by Burnett in Chloe Burnett, 'Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach', 6 *World Tax Journal* 40 (2014), at 40-76. Notably, conceptually the problem does not lie with the debtor (i.e., at the expenditure side), but in the fact that most modern corporate tax systems are not adequately equipped to tax the foreign creditor's income (i.e., at the recipient side) in the source state, see section 6.3.

4.5.2 Weighing the pros and cons: the cons

4.5.2.1 Tax-transparency of subsidiary companies and hybrid entity mismatch issues

The adopting of such an approach would entail various cons – or. positively formulated: 'challenges' – as well. As said, the group companies included in the tax consolidation would become transparent for corporate tax purposes within the international tax system of the state applying this approach. The ultimate parent company would become the taxable entity. In cross-border scenarios, the group companies would become branches (permanent establishments) of the ultimate parent company (the 'head office').

The transparency of these group companies for corporate tax purposes would lead to an expansion of hybrid entity issues, that is, in the event that other states would continue taxing affiliated corporate entities on an individual basis. This problem may be solved through coordination. For instance, one solution may be to have group companies recognized as a permanent establishment of their ultimate parent company, or even better, as fiscally transparent under the bilateral double tax conventions.[723] Indeed, that would require a negotiation of the double tax convention networks in the international tax regime.

4.5.2.2 Triangular cases and currency exchange rate mutations

Triangular cases involving permanent establishment with source taxed portfolio investment income

Moreover, where a consolidated foreign group company derives passive income that arises in a third state, which is subject to a source tax in that third state, a triangular case would emerge. This problem may be resolved by requiring the state to which the passive income is attributable on the basis of a functional and factual analysis to grant double tax relief with respect to the foreign source tax levied on the passive income.[724] This is not further discussed. That is, as this study in the end advocates a destination basis profit allocation mechanism. That would resolve the triangular case issues conceptually via an alternative means.

Currency exchange rate mutations

Furthermore, as the group would be taxed on its worldwide business income earned, currency issues would occur with respect to the calculation of the double tax relief. Inclusion of the foreign income in the domestic tax base prior to granting double tax relief under the 'credit for domestic tax attributable to the foreign income' methodology would lead to the recognition of

[723] See for a comparison Brian J. Arnold, 'Threshold Requirements for Taxing Business Profits under Tax Treaties', 57 *Bulletin for International Taxation* 476 (2003), at 492. Subsidiaries are not regarded as permanent establishments of their parent company on the basis of Article 5, paragraph 7, OECD Model Tax Convention. It should be noted that e.g. the Dutch Supreme Court nevertheless does not seem to have problems with allowing the cross-border tax consolidation under domestic tax legislation to have effect under the Dutch double tax convention network. See Dutch Supreme Court, Hoge Raad, 16 March 1994, No. 27 764, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1994/191, Dutch Supreme Court, Hoge Raad, 29 June 1988, No. 24 738, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1988/331, and Dutch Supreme Court, Hoge Raad, 13 November 1996, No 31 008, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1998/47, and Dutch Supreme Court, Hoge Raad, 3 February 2012, No 10/05383, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 2012/126. See for some analysis Frank P.G. Pötgens et al, 'Cross-border Fiscal Unities and Tax Treaties: Nothing New under the Sun?', 42 *Intertax* 92 (2014), at 92-105, and C. van Raad, 'Internationale aspecten van het herziene regime inzake de fiscale eenheid', 129 *Weekblad Fiscaal Recht* 85 (2000), and for some analytical comparison Michael Lang, 'CFC Regulations and Double Taxation Treaties', 57 *Bulletin for International Taxation* 51 (2003), at 51-58.

[724] See for example, Court of Justice, case C-307/97 (*Saint Gobain*) in which the court adopts a similar approach. On triangular cases see e.g. Maarten F. de Wilde, 'Over samenloop van verrekening en vrijstelling onder belastingverdragen',136 *Weekblad Fiscaal Recht* 855 (2007). Notably, under Article 76(2) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS), the credit may be shared among the countries involved subsequent to the application of the sharing mechanism referred to in Chapter 6 of the CCCTB Proposal. This is not further discussed.

as many currency results for corporate tax purposes as the group has business activities in taxing jurisdictions – i.e., if all countries involved employed their own currencies.

Save for the exception of scenarios where pragmatic functional currency tax reporting rules have been adopted, this may lead to practical difficulties in determining the amount of double tax relief to be granted. The calculations in sections 4.4 and 5.3.4 of Chapter 3, however, reveal that these challenges would be by no means insurmountable.[725] Matters accordingly seem to be more of a practical nature than of a theoretical nature. Notably, currency exchange effects under the final system are addressed in Chapter 6, section 4.5.3.

> The exemption of currency exchange rate would introduce distortive properties into the system

An alternative to recognizing currency exchange results for corporate tax purposes would be to exempt them from the taxable corporate base. Although this would be administratively convenient, such an approach would not be conceptually sound.[726]

Currency exchange risks are actual commercial risks. These risks – in the event that they have not been hedged – may lead to actual mutations in the group's equity capital. In my view, this economic reality should be acknowledged for corporate tax purposes, irrespective of the technical difficulties that may emerge from this when calculating the corporate tax liability.[727-728]

Market distortions that emerge as a result of mutual fluctuations in exchange rates should be resolved outside the area of corporate taxation. Solutions may, for example, be found in a harmonized monetary policy (such as, for example, the monetary union within the European Union). This matter is not further discussed as it falls outside this study's subject of analysis.

4.5.2.3 Profit attribution by reference to the OECD's two-step analysis – also, see Chapter 6

The allocation of the group's business profits to taxing jurisdictions would take place on the same basis as with respect to the allocation of profits to permanent establishments. The allocation of business income would occur on the basis of the OECD's two-step analysis.

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[725] Analytically valid solutions have already been developed for example by the Dutch Supreme Court in the late 1950s and early 1960s. See Dutch Supreme Court, Hoge Raad, 4 May 1960, No. 14 218, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1960/163 and Dutch Supreme Court, Hoge Raad, 29 April 1959, No. 13 892, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1960/164 (*Rupiah*) confirmed by Dutch Supreme Court, Hoge Raad, 10 March 1993, No. 28 017, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1993/209, as well as Dutch Supreme Court, Hoge Raad, 5 December 2003, No. 37 743, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 2004/139 (*Cruzeiro*). Furthermore, see Dutch Supreme Court, Hoge Raad, 31 March 1954, No. 11 518, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1954/180. See for some analysis Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international* (2011), at section 2.7. Notably, the Dutch tax legislator has adopted functional currency tax reporting rules for administrative convenience reasons (Article 7, fifth indent, Dutch CITA). These are not further discussed. The Court of Justice seems to take a similar stand in case C-293/06 (*Deutsche Shell*). This jurisprudence has provided the inspiration for the numerical examples set forth in Chapter 3 of this study.

[726] See for a comparison, Court of Justice, case C-293/06 (*Deutsche Shell*).

[727] Hedge accounting could be applied for corporate tax purposes in scenarios where the currency exchange risks have been hedged. The aforementioned issues with regard to the corporate tax implications of currency exchange results would then not arise as currency risks would not occur to the extent that these are effectively hedged.

[728] The exempting of currency exchange results realized on shareholding interests under the application of a participation exemption regime would be conceptually unsound for comparable reasons. Such an exemption should only apply in my view to secure the single taxation of the underlying (business) profits realized by the company in which the shareholding interest is held. Namely, with respect to currency exchange results realized on the shareholding interest no economic double taxation occurs. Hence, there is no need to apply the exemption for these income items. Cf. Dutch Supreme Court, Hoge Raad, 4 May 1960, No. 14 218, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1960/163 and Dutch Supreme Court, Hoge Raad, 29 April 1959, No. 13 892, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1960/164 (*Rupiah*). Contra Dutch Supreme Court, Hoge Raad, 9 June 1982, No. 21 142, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 1982/230.

The significance of legal transactions between affiliated corporate entities would be strongly reduced. In the event that groups would be treated as a single taxable entity, legal transactions within the group would merely have an indicative value for the purpose of allocating business profits, just as is currently the case with respect to reported internal dealings between a head office and its permanent establishment. This may be regarded as problematic in tax practice.

However, it can be considered true that intra-group legal transactions are not necessary to the allocation of business income to taxing jurisdictions under the transfer pricing methodology; neither in theory, nor in practice. The possibility to allocate income amongst a permanent establishment and its head office – an environment where legal transactions are absent – on the basis of the two-step analysis proves this thesis. Under the transfer pricing methodology, a factual and functional analysis may suffice to identify the functions performed, the assets used and the risks assumed, to which the arm's length principle is subsequently applied. It has already been applied in international tax practice when business income is allocated to permanent establishments.[729]

It should however be noted at this point in this study that the analysis will ultimately favor ending-up at a profit allocation approach based on the destination principle. The division of the tax base is further assessed in Chapter 6.

4.5.2.4 Tax return filing, auditing and mutual administrative assistance

The unlimited tax liability for corporate groups in conjunction with a credit for domestic tax attributable to foreign income would lead to considerable changes in the tax auditing and tax return filing practice.

The tax returns would be based on the consolidated commercial annual accounts of the entire group rather than the domestic accounts of the part of the group that is subjected to corporate tax within a respective tax system. In addition to this, the (computerized) filing systems employed by the tax authorities would need to be amended. Significant amounts of (possibly to be translated) data should be administered. Taxable amounts would need to be extracted from commercial annual accounts that may be based on various accounting practices (e.g. US GAAP or IFRS).

Moreover, with respect to determining taxpayers' corporate tax position, obligations for taxpayers to provide for relevant information, legal remedies, international administrative assistance and cooperation, as well as mutual agreement and arbitration procedures, may become even more important than has been the case until today. The need to apply provisions of this nature in the respective states' international tax systems (i.e., administrative provisions in domestic legislation and double tax conventions, as well as the Mutual Assistance Directive and Arbitration Convention in an European Union context) would likely increase.

This may lead to administrative difficulties. However, these practical challenges would not necessarily be insurmountable. As the OECD, for instance, submits regarding the application of the profit split method, *"it would be reasonable to expect that taxpayers be ready to provide tax administrations with the necessary information on the foreign associated enterprise party to the transaction, including the financial data necessary to calculate the profit split."*[730] At the end of the day, it will be the required (political) willingness of states to assist each other administratively that may prove to be the bottleneck for proper functionality of the approach as advocated in this study. However, regarding the weight of the political willingness of nation states in reality should also be recognized for what it is – politics rather than academics.

[729] Arguments opposing this position can be considered an implicit plea against the conceptual soundness of the transfer pricing methodology – i.e., the tool to allocate business income to taxing jurisdictions employed by states today – rather than an argument against the approach as advocated in this chapter.
[730] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Chapter III at par. 3.21.

Nevertheless, in the event that the proposed system would lead to practical problems in assessing corporate tax – e.g. were practice to show that the relevant information for determining the taxpayer's tax position would not be made available – the solution to that problem needs to be sought in improving international administrative proceedings, rather than in the rejection of the theoretical analysis.[731] The emerging global market just calls for international administrative assistance. As already mentioned earlier, recent developments in the area of 'country-by-country reporting' show evidence of a trend towards an international consensus on the need for global transparency in tax administrative matters.[732]

4.5.3 Remaining challenges to be resolved

4.5.3.1 Obstacles imposed abroad still in place

The approach advocated until this point would not resolve all theoretical problems that have been addressed in the introductory chapter. It would, for instance, not provide an answer to the obstacles imposed by foreign international tax systems in their international tax systems.[733] That matter, however, proves to be theoretically resolvable as previously demonstrated in Chapter 3; that is, if the nation state involved would be politically willing to fairly amend its international corporation tax system.

4.5.3.2 Disparities and inadequacies in the tax base definition methodologies still in place

Furthermore, the advocated system would not provide for a solution to the remaining market distortions that are caused by the disparities and inadequacies that have not yet been assessed until this point of the study. For instance, the approach advocated up until this point does not deal with the double taxation and the double non-taxation issues that result as a consequence of differentials in income qualification, or the interpretation of facts and circumstances for corporate tax purposes.

Fundamentally, the advocated approach would, for instance, not provide for a solution to the current (arbitrary) differences in corporate tax treatment between *third party* debt and equity financing arrangements.[734] Proceeds from third party debt financing arrangements would remain to be recognized for corporate tax purposes, while proceeds from third party equity arrangements (at least at the level of the paying agent) would not. The tax base definition is touched upon in the upcoming Chapter 5.

4.5.3.3 Disparities and inadequacies in the profit division methodologies still in place

The geographic attribution of economic rents remains problematic

Moreover, the system at this point does not provide an answer to the distortions in the international tax regime that are caused by the inadequacies in the methodology that is generally used by nation states to divide the 'international tax pie' – i.e., the issue of taxable profit allocation accordingly. Although the subject of geographic tax base division is touched upon in Chapter 6, the following remarks are worth noting at this point.

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[731] See for a comparison Maarten F. de Wilde, 'Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy', 38 *Intertax* 281 (2010), at sections 4.4 and 7.2.

[732] For some reading and analysis, see OECD, OECD Committee on Fiscal Affairs, *Memorandum on transfer pricing documentation and country-by-country reporting*, OECD Publishing, Paris, 3 October 2013, OECD, OECD Committee on Fiscal Affairs, *Public Consultation; Discussion draft on Transfer pricing Documentation and CbC Reporting*, OECD Publishing, Paris, 30 January 2014, and OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*, OECD Publishing, Paris, 16 September 2014.

[733] See for a comparison Maarten F. de Wilde, 'Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy', 38 *Intertax* 281 (2010), at sections 2-9.

[734] See Ruud A. de Mooij et al, 'An applied analysis of ACE and CBIT reforms in the EU', 18 *International Tax and Public Finance* 93 (2011), at 93-120.

First, it would remain troublesome to properly allocate business profits, for instance the multinationals' firm-specific rents, to taxing jurisdictions as the international allocation of income would still take place on the basis of the generally applied but fairly criticized concepts of permanent establishment[735] and the arm's length principle.[736]

It would remain conceivable, for example, to shift business income to low-tax jurisdictions through strategically arranging the transfer prices relating to the intra-group trading of firm specific rent-yielding assets, such as intellectual property portfolios that provide unique monopoly rights. As there are no outside markets for trading these often valuable intangible assets, it is generally impossible to find comparable transactions to determine the transfer price for these interaffiliate transactions by reference to the arm's length principle. This provides multinationals with some leeway to reduce their overall tax burden through strategically arranging the intra-firm transfer prices.[737] Furthermore, it would remain impossible, for instance, to allocate proceeds from a web store to the origin state under the physically oriented permanent establishment threshold.

Troublesome taxation of third party shareholders, creditors, and lessors at source

Second, it would remain troublesome to adequately tax proceeds from inbound investments by *third party* shareholders, creditors, and lessors in the source state.[738] The OECD Model Tax Convention on Income and Capital, the European Union legislation and the international tax systems of various OECD member states typically do not provide suitable instruments in this respect to tax proceeds from (portfolio) shareholders' interests, bonds, leases and license agreements, despite the fact that these proceeds may very well have been realized within the source state.[739]

It is my impression that the reason for this is that the OECD members are traditionally capital-exporting countries. As a consequence of this, typically, less emphasis has been put on the taxation of proceeds from capital imports in the source country. Consequently, the international tax systems of these states are confronted with difficulties in their attempts to tax the income realized, for example, by foreign creditors and licensors in today's globalizing economy.

The UN Model Double Taxation Convention provides countries more room to tax proceeds from capital imports – e.g. outbound interest and royalty payments. This may be explained by the fact that the UN Model, to a greater extent, promotes the interests of the traditionally capital-importing countries – i.e., developing countries and countries with transition economies.

It is true that various OECD member states have adopted dividend, interest and royalty withholding tax legislation in their international tax systems. Yet, it should be noted that, particularly within the context of the European Union, the levying of withholding taxes in effect

[735] See for example Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006), at 266-280, Arthur J. Cockfield, 'The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles', 56 *Bulletin for International Taxation* 606 (2002), at 606-619, and Michael J. Graetz, 'The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies', 54 *Tax Law Review* 261 (2001), at 261-336.
[736] See for example Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', 62 *Bulletin for International Taxation* 201 (2008), at 201-215, and Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 103-111, and Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286. See also Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', *2 World Tax Journal* 3 (2010), at 3-17.
[737] See for a comparison Ruud de Mooij, 'Will corporate income taxation survive?', 3 *De Economist* 153 (2005), at 292 and Avi-Yonah, *ibidem*.
[738] See for a comparison Eric C.C.M. Kemmeren, 'Source of income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach', 60 *Bulletin for International Taxation* 430 (2006), at 430-452.
[739] See for a comparison Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Parts I, II & III)', 8/9 *Intertax* 216 (1988), at 216-228, 10 *Intertax* 310 (1988), at 310-320 and 11 *Intertax* 393 (1988), at 393-402, and Eric C.C.M. Kemmeren, 'Source of income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach', 60 *Bulletin for International Taxation* 430 (2006), at 430-452.

is not always possible. The European Union Parent-Subsidiary Directive, for example, does not consistently allow for the imposition of a dividend withholding tax on outbound dividends to certain foreign minority – i.e., third party – shareholding companies. The same is true regarding withholding taxes on outbound interest and royalty payments to foreign third party creditors and/or licensors under the European Union Interest and Royalty Directive. Furthermore, the possibilities for European Union Member States to levy source taxes at the gross amount on outbound dividend, interest and royalty payments are also limited in scenarios falling outside the scope of application of these Directives. The Court of Justice does not allow European Union Member States to levy final source taxes on the gross amount with respect to outbound dividend distributions and interest and royalty payments in the event that economically comparable domestic payments – i.e., payments not crossing the tax border – are exempt from tax or are taxed at the net amount.[740]

4.5.4 Remaining challenges do not render current analysis invalid

The recognition of these remaining issues, however, does not make the inferences made thus far in the current analysis invalid. The remaining issues identified in the areas of tax base definition and tax base allocation fall outside the confines of the present analysis, as this chapter has merely dealt with the taxable entity definition.

The identified issues reveal that the work is not done yet. The international tax regime also requires an adequate tax base definition and an adequate tax base division key. The approach advocated in this chapter therefore provides only part of an answer. The remaining pieces in the international tax jigsaw puzzle remain left to be discovered. These will be addressed in the upcoming chapters 5 and 6.

4.6 Final remarks

This chapter is devoted to answering the question of who to tax in an alternative international corporate tax regime. What may be considered the appropriate taxable entity or 'tax subject' in a corporate tax 2.0?

An answer lies in tax consolidation; treat the multinational as a single taxable entity for corporate tax purposes. To define the group for corporate tax purposes, two criteria should be adopted. Tax consolidation should apply with respect to:

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

Moreover, tax consolidation should be allowed in both domestic and cross-border scenarios. The ultimate parent company could be assigned as the (principal) taxpayer for tax assessment purposes.

Following the approach established in the previous chapter, the group should be subject to an unlimited corporate tax liability in each taxing jurisdiction in which it exceeds a minimum threshold of economic activity. In cross-border scenarios, double tax relief should subsequently be available by means of the credit for domestic tax that is attributable to foreign income as developed in Chapter 3.

The adoption of such an approach would remove all distortions that are currently caused by the commonly adopted approach to deal with each group company as a single taxable entity (resident or non-resident taxpayer) for corporate tax purposes. The corporate tax treatment of corporate groups and single corporate entities would be brought up to the same level in both

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

domestic and cross-border scenarios. It would accordingly cancel out all unilaterally imposed distortions in the corporate taxation of multinationals. Corporate tax burden and revenue levels would not be influenced by the multinationals' legal structuring or the question of whether business is conducted in a domestic or cross-border context.

The need for *ad hoc* correction mechanisms would become superfluous. I favor treating the group as the taxable entity for corporate tax purposes over the separate entity approach, basically because it is principally founded on economic reality. Deal with the group as a single entity for tax purposes as it is a single economic entity from a business economics perspective.

The approach taken merely requires acceptance that the problems initiated by taking the separate entity assumption as a starting point in corporate taxation cannot be resolved within the same tax framework that created these problems. Although it should also be said that the bottleneck for a proper functioning of such an approach would lie in the required willingness of states to tax-coordinate and assist each other administratively.

The approach advocated until this point of the current analysis would not resolve all problems in international taxation. It would not remove market distortions that occur due to remaining disparities or obstacles imposed abroad. Moreover, it would not provide an answer to the distortions caused by the remaining inadequacies in the methodology generally employed by states to mutually design the tax base and divide it between the countries in which the multinational firm operates its business activities. The first piece of the international tax jigsaw puzzle nevertheless seems to have fallen into place. This paves the way for discovering the remaining ones in the upcoming Chapters 5 and 6.

– Chapter 5 –

Economic rents as taxable base

Chapter 5 Economic rents as taxable base

5.1 Introduction

This chapter further builds on the observation set forth in Chapter 2 that the notion of fairness in the international tax regime ultimately calls for a worldwide coordination of the international corporate tax systems of nation states. That is, an approximation of tax systems into an adequately operating coherent international tax regime is called for.

After addressing the appropriate taxable entity in the previous chapter, the current chapter is devoted to answering the question of how to identify the taxable business proceeds for corporation tax purposes in an alternative international tax regime; that is, how to identify the tax object.[741] What may be considered the appropriate taxable base or 'tax object' in a corporate tax 2.0 other than the nominal return to equity standard that is typically used in corporate taxation?

Taxing the multinational's economic rents…

This analysis is inspired by the 'Schanz-Haig-Simons' concept of income, i.e., the 'capital accrual theory' defining income as the sum of consumption and actual capital accrual.[742] The argument made is that the international tax regime should autonomously identify a taxable base for corporate tax purposes by referring to the firm's economic rents derived, as that amount constitutes the remuneration in return for the provision of the production factor of enterprise.

The analysis builds on the widely acknowledged notion that multinational firms derive rents. As mentioned in the previous chapters, by operating their global business activities in a financially economic and organizationally integrated manner, multinationals have proven able to produce above-normal investment returns, commonly addressed as rents. That is, they have been able to derive investment returns exceeding the normal returns on the production factors of labor and capital.

The goal of the approach taken is to arrive at a taxing system where basically only the above normal returns are taken into account for corporate tax base calculation purposes. Various commentators have resorted to advocating the approach of taxing rents instead of profits.[743] Such an approach could be achieved technically by means of an allowance for corporate equity or via a cash flow tax.

As to be qualitatively demonstrated by means of numerical examples and formulaic analyses, the common return to equity standard produces inequities and distortions in the financing decisions. That is, as it tax-favors debt over equity financing.[744] It will also be shown that the

[741] See for some comparison Richard J. Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World', 2 *World Tax Journal* 291 (2010), at 315.
[742] See Georg Schanz, 'Der Einkommensbegriff und die Einkommensteuergesetze', 13 *Finanzarchiv* 1 (1896), at 1-87, Robert M. Haig, 'The Concept of Income: economic and legal aspects', in Robert M. Haig (ed.), *The Federal Income Tax* (1921) and Henry C. Simons, *Personal Income Taxation* (1938). For extensive analyses on the S-H-S concept of income, see Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapters 1 and 2, and Victor Thuronyi, 'The Concept of Income', 46 *Tax Law Review* 45 (1990), at 45-105.
[743] See e.g., Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010, Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 De Economist 417 (2007), at 417-448.
[744] See e.g., Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), Ruud A. de Mooij et al, 'An applied analysis of ACE and CBIT reforms in the EU', 18 *International Tax and Public Finance* 93 (2011), at 93-120, Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010, Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 De Economist 417 (2007), at 417-448, as well as Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, and Serena Fatica et al, 'Taxation Papers; The Debt-Equity Tax Bias: Consequences And Solutions', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2012:33.

arbitrage becomes exacerbated under the use of the classical system of corporate taxation addressed in the previous chapter.

Would enhance fairness…

The argument is made that fairness may be enhanced when nation states decide to make use of a tax base foundation concept containing an allowance for corporate equity ('ACE'). The idea is to appropriately mitigate the financing discrimination issues that arise under their typical nominal return to equity based international tax systems. An ACE-based foundation concept to tax business income has the following equitable properties. It produces equal to statutory average effective tax rates; that is, as it taxes business cash flows. Furthermore, marginal financing decisions are not affected by corporate taxation since the effective marginal tax rate under an ACE is nil. The financing distortion issues would accordingly be mitigated in an equitable and neutral manner. Furthermore, the distortions that arise under a common corporate tax in the presence of differentials in tax depreciation and economic depreciation would be mitigated under an ACE as well, because the present values of depreciation and ACE allowances are independent of the rate against which assets are written-off in tax bookkeeping. The effects of the system are demonstrated via numerical and formulaic examples.

With regards to equity investments in minority shareholdings, the argument is made that arising economic double taxation issues should be resolved by means of a double tax relief mechanism akin to the mechanism advocated in Chapter 3. The economic double tax relief mechanism addressed in the current chapter is referred to as the 'indirect tax exemption'. It would basically operate as an indirect tax credit. That is, however, with the exception that the credit is calculated by reference to an amount equal to the domestic tax that can be attributed to the excess earnings of the respective entity in which the equity investment is held – accordingly: indirect tax exemption = (grossed-up net proceeds from a participation / worldwide income) * domestic tax on worldwide income. To efficiently arrive at a single taxation of the business cash flows involved, the economic double tax relief mechanism would be combined with a 'loss recapture mechanism' and a 'profit carry forward mechanism'. The neutral operation of such a double tax relief system is demonstrated by means of numerical and formulaic examples.

But only as a next step…

However, such an approach would again provide only a next answer to the distortive allocation of corporate tax among corporate taxpayers and between states in a global marketplace. That is, in addition to the treatment of the multinational group as a single tax unit elaborated upon in the previous chapter. The approach advocated in this chapter to tax rents would not resolve the distortive allocation of the tax base in the current international tax regime.

Indeed, the geographic division of the tax base would remain to take place by reference to the common tax jurisdiction concepts, such as the permanent establishment and the place of effective management. The allocation of the tax base would remain to revolve around the arm's length standard. The advocated system up until this point would not resolve the distortions in the investment location decision that arise under the current international tax regime. It would not resolve the tax-induced arbitrage in the establishment of tax jurisdiction. It would furthermore remain problematic to adequately allocate the tax base geographically to the taxing jurisdictions in which the firm undertakes its economic activities.

Nevertheless, the definition of the tax base by reference to firm rents may be considered to provide the second piece of the international tax jigsaw puzzle. Perhaps, the mitigation of the financing discrimination renders this piece to have fallen into place as well. This would accordingly pave the way for discovering the final piece of the puzzle in the remaining Chapter 6, i.e., a proper geographical tax base division key.

5.2 Business income as remuneration for production factor of enterprise

5.2.1 What is business income? The S-H-S concept of income

To answer the question as to how to define the desired taxable base first requires an answer to the underlying question of how to understand the concept of business income conceptually. What is business income?

The underlying theoretical rationale for defining the proper corporate taxable base may be provided by the capital accrual theory that is founded on the Schanz-Haig-Simons ('S-H-S') concept of income.[745] Under the S-H-S concept of income, income (Y) is defined as the sum of consumption (C) and actual capital accrual (S), i.e., Y = C + S. At the same time, income (Y) can be seen as the sum of remunerations paid by firms to households in return for the provision of the production factors of capital (R), labor (W) and enterprise (R*) by these latter mentioned households to the first mentioned firms.[746]

The remuneration for the provision of the production factors of labor and enterprise, often referred to as active sources of income, respectively are classified as wages and business income (the latter may also be referred to as business cash flow, excess earnings, economic rents, or inframarginal returns). The remunerations for the provision of the production factor of capital, both monetary capital and tangible and intangible capital (on the basis of e.g. (portfolio) shareholders' interests, bonds, leases and license agreements), often referred to as passive income, are typically classified as portfolio investment returns, or normal returns. In this respect one may think of portfolio dividends and interests, as well as leasehold and royalty payments. Households, subsequently, employ the aggregate of these remunerations – the income derived – for consumption or savings, accordingly constituting the S-H-S concept of income as Y = C + S.

The introduction of an income tax in this basic model reveals that, theoretically, one may evenly decide between introducing a levy at the economy's supply side (production factors) and the economy's demand side (consumption). A tax introduced at the supply side is typically referred to in tax law as a direct income tax. A tax introduced at the demand side is typically referred to in tax law as an indirect consumption tax. Obviously, a combination of the two types of levies is feasible as well, and is currently the reality in most countries.

In acknowledgement of the reality that all taxes are ultimately borne by individuals, it is fair to say that conceptually no real difference exists between an income tax and a consumption tax,[747] with the exception of the tax treatment of savings income, which typically are taxed under an income tax while being exempt from tax under a consumption tax.[748] This also

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[745] See Kevin Holmes, *The Concept of Income; A Multidisciplinary analysis* (2001), at Chapters 1 and 2, as well as Victor Thuronyi, 'The Concept of Income', 46 *Tax Law Review* 45 (1990), at 45-105. To enable taxation, accrued income is attributed to taxable periods.

[746] In the event that solely the production factors of capital (R) and labor (W) are distinguished, the remuneration for the provision of capital is typically considered to break down into two components, a normal market return rate (R) and a super normal market return rate (i.e., (R*); or (R-I) for that matter). The super normal market return rate then typically is also referred to as business cash flow, excess earnings or economic rents. See Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 41-45. In the above normal returns, I recognize the remuneration for the provision of the production factor of enterprise. Accordingly, that renders moot the need to distinguish between components R and R* as the remuneration for the provision for the production factor of capital.

[747] See also Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 41-45. See for a comparison, Peter Harris, 'The CCCTB GAAR: A Toothless Tiger or Russian Roulette?', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012), 271-297, who notes at 278 that: *"the legislator cannot effectively prescribe who is to bear the burden of a tax. And this is the reason why, in terms of effect, the distinction between a direct tax and an indirect tax is artificial. The distinction can only relate to a legislator's intention and not the actual fashion in which a tax is borne."*

[748] See for a comparison Joseph Bankman et al, 'The Superiority of an Ideal Consumption Tax Over and Ideal Income Tax', 58 *Stanford Law Review* 1413 (2006), section I. Bankman et al argue that savings income should not be taxed as it tax treats consumption 'today' more favorably over consumption 'tomorrow' and accordingly distorts decisions on when to consume. See on this matter, for instance, Robert E. Hall, 'The Effects of Tax Reform on Prices and Asset Values', 10 *Tax Policy and the Economy* 71 (1996), at 71-88. See also Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 44. Contra, Reuven S. Avi-Yonah, 'The Three Goals of Taxation', 60 *Tax Law Review* 1 (2006-2007). Avi-Yonah argues that savings income should be taxed. This issue is not further discussed in this study for being considered an analytically separate from the question as to how to tax business income. Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European*

means, again with the mentioned exception of the taxation of savings, that no conceptual difference exists between a consumption tax on the one hand and a wage tax and a business income tax (i.e., a business cash flow tax) on the other,[749] aside from the difference in timing. The first mentioned levies are imposed *ex ante*, or at the time the wage income or business income has been derived, prior to consumption, while the latter mentioned levy is imposed *ex post*, that is, upon the spending and subsequent consumption of the derived wage or business income.

5.2.2 Taxing the returns to the production factor of enterprise: economic rents

5.2.2.1 Taxing the business proceeds…

To the extent that the various production factors are to be taxed in separate tax processes, it follows that the quest for a (direct) impost on actual business income should necessarily focus on excess earnings or economic rents to be imposed on entrepreneurs. The remuneration for the provision of labor – wages – would accordingly be taxed under a wage tax imposed on workers. The remuneration for the provision of capital – portfolio investments returns – would be taxed under a savings income tax imposed on portfolio investors. The remuneration for the provision of enterprise – business cash flow – would be taxed under a business income tax imposed on entrepreneurs.

That is, at least, as long as one assumes that a fair tax should acknowledge economic reality and as long as one assumes that fairness calls for non-overlapping taxes, i.e., the imposition of various direct taxes regarding the remunerations for the same production factors. Moreover, this holds true as long as one does not desire to eradicate all direct taxes in the international tax regime replacing them with consumption taxes, as is sometimes advocated in the economic literature.[750]

Notably, it may be considered arguable that the taxpayer, under an ideal business income tax, should be the business enterprise itself, i.e., the commercial or industrial activity of an independent nature undertaken for profit rather than the entrepreneur operating it. [751] Such an approach would make such an income tax a full-fledged *in rem* tax. The tax object – the business proceeds or economic rents – and the tax subject – the business enterprise that is carried on – would be merged into one another. That is, the *ad personam* component and the *in rem* component of an income tax would be merged.

5.2.2.2 … of the firm involved

It may however be doubtful that such an approach would be desirable. This study upholds the position that an income tax has and should have both an *in rem* and an *ad personam* component. The taxable object, i.e., the business proceeds or economic rents, and the

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Commission Directorate-General for Economic and Financial Affairs Economic Paper 2006:264, at 18 referring to the absence of universal theoretical consensus on the proper tax treatment of taxing capital income.

[749] See also Sijbren Cnossen, 'A VAT Primer for Lawyers, Economists, and Accountants', 124 *Tax Notes* 687 (17 August 2009), at 687-698, as well as Charles E. McLure, 'Economic, Administrative, and Political Factors in Choosing a General Consumption Tax', 46 *National Tax Journal* 345 (1991), at 345-358.

[750] The question on the desirability of simultaneously taxing 'income' and 'consumption' is not further discussed. See on this matter Joseph Bankman et al, 'The Superiority of an Ideal Consumption Tax Over and Ideal Income Tax', 58 *Stanford Law Review* 1413 (2006) and Reuven S. Avi-Yonah, 'The Three Goals of Taxation', 60 *Tax Law Review* 1 (2006-2007), 60 *Tax Law Review* 1 (2006-2007). Notably, I tend to agree on the need of adopting both taxes simultaneously. The application of a mere destination based consumption tax in a global market would favor net consuming states over net producing states (a mere origin based income tax would operate in an opposite manner). That would entail inter-nation inequities. The presence of both an origin based income tax and destination based consumption tax could balance out the interest of net producers and consumers. Origin versus destination is a matter further discussed in Chapter 6.

[751] The definition of a business enterprise has been taken from Lee Burns et al, 'Taxation of Income from Business and Investment', in Victor Thuronyi et al, *Tax Law Design and Drafting* (1998), at Chapter 16. Please note that, for illustration purposes, established Dutch case law in the field of direct taxation defines a business as a durable organization of capital and labor with which the taxpayer takes part in the economic process, while having the objective of realizing a profit. The taxpayer's objective of profit realization is considered to be met in the event that the earning of such a business profit is reasonably foreseeable.

taxable entity, i.e., the entrepreneur, should be kept analytically distinguished from one another.

In my view, an income tax should be imposed on a person as it is a person rather than the business operation that produces the income and pays the tax impost.[752] In the end it is the entrepreneur that produces the income. It is the human capital – the human intellectual intervention – that leads to the creation of actual wealth. Value may be added to things only through the actions of people, irrespective of whether or not a device (capital) is used.[753]

The assets that are employed in the business process merely provide means, i.e., the instruments that enhance workforce productivity, whereby workforce productivity can be described as the amount of goods and services produced by workers in any given amount of time. The business operation provides the means involved, or the instrument operated by the entrepreneur to produce economic wealth accrual. Things such as assets and businesses themselves do not produce income. Essentially, no money is made when the shop is closed.

As the business proceeds from operating a business enterprise are derived by the entrepreneur, it would subsequently be the entrepreneur that is regarded as the taxpayer for business income tax purposes. The taxpayer involved may be an individual or a firm – i.e., a (multinational) group of affiliated corporate bodies governed by its common corporate management. Accordingly, the business income tax involved would in the end be levied from the firm operating the business enterprise as the economic entrepreneur through its corporate management. The ultimate parent company could function as the (principle) taxpayer for corporate tax assessment purposes. This holds up, in my view, regardless of who ultimately bears the corporate tax imposed. The tax incidence, as previously stated, is unknown.

In summary, as business income may be identified as remuneration for the provision of the production factor of enterprise, the focus should lie on taxing those elements that actually constitute the remuneration for this production factor: economic rent. The income derived from the other production factors would accordingly be taxed under separate taxes, e.g. wages under a wage tax and portfolio investment returns under a savings tax. It also follows that these items (wages, portfolio returns) would need to be tax-deductible in determining the tax base for business income tax purposes. A corporate income tax should not tax wage income; it should also not tax savings income. These items should be taxed in the hands of the worker and the portfolio investor respectively.

To identify the most suitable taxable base in this respect, the following sections scrutinize a range of alternative tax bases identified in practice and doctrine. It should be noted that the stepping stones and inspiration for the analysis have been found in the work of Howell Zee.[754]

5.3 No tax environment

5.3.1 Assessing the investment returns of 'Ben Johnson Dinghy Selling Company'

To illustrate the effects of the current return to equity-based corporate income tax systems adopted throughout the world, as well as the effects under a range of alternative tax bases recognized in the literature, it may prove worthwhile to illustrate things by means of a stylized running numerical example, a base case. I commence with a 'no tax environment' as a point of reference.

Let us return to our corporate taxpayer 'Ben Johnson Dinghy Selling Company' and its dinghy business activities from Chapter 3.

[752] See for a comparison the remarks forwarded by Kemmeren that only individuals produce income. See Eric C.C.M. Kemmeren, 'Source of income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach', 60 *Bulletin for International Taxation* 430 (2006), at 430-452.
[753] Cf. Eric C.C.M. Kemmeren, 'Source of income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach', 60 *Bulletin for International Taxation* 430 (2006), at 430-452.
[754] See particularly Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448.

- Let us assume that Johnson decides to invest in a business activity, a direct investment in a dinghy selling project in period 1. The business activities are inconsequentially performed, either domestically or abroad, as this chapter seeks to identify the proper taxable base rather than its geographic location. That topic is dealt with in isolation in Chapter 6.
- The investment amounts to €10,000 ('1'). Johnson finances this investment partly with debt ('α') – an interest bearing bank loan – and partly with equity ('1 – α'), such as non-repatriated earnings or newly issued equity capital. The bank loan amounts to €6,000. The interest rate ('r') equals 4% (the inflation component has been included). The issued principal amount needs to be repaid in period 2. Accordingly, the equity investment equals €4,000. The opportunity cost of capital – i.e., the return on an alternative investment in a low-risk normal market rate return yielding investment in a debt-financing instrument – ('r') equals 4% as well (again, including the inflation component and excluding the risk component – see hereunder). Notably, the concept of 'opportunity costs of capital' may be acknowledged upon the recognition that Johnson could also have invested its equity capital by lending it to a third party at a 4% interest rate rather than investing it in a dinghy sales activity.
- Let us suppose that Johnson's investment is profitable. Johnson's activities produce economic rents. The gross return equals 5% in period 2. Accordingly, ultimo period 2, the investment yields a gross return of €10,500 ('1 + ρ'). The amount of interest paid equals €240.[755] The opportunity cost of the equity capital is equal to €160.[756]

5.3.2 The benchmark: investment returns of 'Ben Johnson Dinghy Selling Company' in a no tax environment

In a no tax environment, i.e., our point of reference to illustrate the effects under the diverging tax bases in the following sections, Johnson's business activities produce the following business cash flows (fig. 32):

Fig. 32. Johnson's Cash Flow Statement

	Period 1	***Period 2***
Johnson's Cash Flow Statement		
Real Transactions ('R')		
Investment	– 10,000[757]	
Gross Return on Investment		+ 10,500[758]
Aggregate	– 10,000[759]	+ 10,500[760]
Financial Transactions ('F')		
Debt Issuance	+ 6,000[761]	
Repayment Principal Amount		– 6,000[762]
Interest Paid		– 240[763]
Aggregate	+ 6,000[764]	– 6,240[765]
Aggregate 'R' and 'F'	– 4,000[766]	+ 4,260[767]

The net outbound cash flow in period 1 equals €4,000, an amount equal to the invested equity capital. The net inbound cash flow in period 2 equals €4,260. The net return to the invested equity capital ('v'), €260 or 6.5%,[768] is comprised of two components. The first component

[755] 0,04 * 6,000 = 240.
[756] 0,04 * 4,000 = 160.
[757] – 1.
[758] 1 + ρ.
[759] – 1.
[760] 1 + ρ.
[761] α.
[762] – α.
[763] – α.r.
[764] α.
[765] – α.(1 + r).
[766] – (1 – α).
[767] (1 – α) + (ρ – α.r).
[768] (4,260 / 4,000) – 1 = 0.065. 0.065 * 100% = 6.5%. Accordingly: v = (1 – α) + (ρ – α.r) / (1 – α) – 1 = (ρ – r) / (1 – α) + r.

constitutes the economic rent or excess earnings, i.e., Johnson's remuneration for the provision of the production factor of enterprise (business cash flow). This amounts to €100, i.e., 2.5% of the invested equity capital.[769] The second component constitutes the normal market return to equity (including inflation) or the opportunity costs of capital, i.e., the remuneration for the production factor of capital (savings income). The normal market return equals €160, i.e., 4% of the invested equity.[770]

5.3.3 Leverage explained

As Johnson derives excess earnings, he will be able to push the return upwards to the invested equity capital by financing its investment in the dinghy sales activity with a higher percentage of debt capital. This already is apparent as Johnson, in our example, finances the investment with 60% debt and, accordingly, yields a return on its equity investment of 6.5%, exceeding the return that he would have yielded if the investment would have been fully financed with equity capital. In the event that the return yielded amounts to €500, the return rate equals 5%.[771]

Assuming that our investor Johnson strives for profit optimization, Johnson will rationally continue to invest its equity capital in the profitable dinghy sales activities until the marginal return equals the opportunity costs of capital of 4%, in our example.[772] Johnson will rationally cease its investment in dinghy sales activities only when the return yielded drops below the opportunity costs of capital. Viz., in such a case it proves more profitable to just open up a savings account. Should Johnson nevertheless irrationally maintain its investment activities in such a case, the gross return rate, for instance, equals a mere 3.5% (or €350), such a return would comprise of the aforementioned two components as well. On the one hand, Johnson derives a normal market return equal to 4% (€160). On the other hand, Johnson derives negative excess earnings equal to €50 (or 1.25%) in the negative.[773] That is, a marginal loss-rendering investment accordingly.

In reality, however, the presence of commercial risks involving the investment would affect the amount of debt financing relative to the equity financing. The rate of return to equity that the shareholders would require would differentiate dependent on the manner in which the respective investment has been financed. To the extent that the investment is partly financed with debt, the shareholders involved would require a higher return on the equity provided to compensate for the increased level of risk that they incur due to the taking-up of debt capital by the firm; for instance, as a result of their subordinated position relative to the creditors involved and the firm's lack of obligation to repay the principal amount. The higher the debt-to-equity ratio, the higher the required return to equity would be ('(un)levered cost of equity capital'). This stems from the notion that the value of a firm in an efficient market is determined by reference to its earning power – taking into account the risks incurred from the utilization of the firm's assets in its business processes and the market value of collateral provided[774] – rather than the manner in which the firm's activities have been financed.[775] The normal return to capital ('r'), in consequence, changes in reality depending on the firm's earning power and its financing structure. The normal return further differs per chosen type(s) of financing arrangement(s) in the debt-equity spectrum. Only the return in excess of the normal return rate would accordingly constitute the economic rent.

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[769] 2.5% * 4,000 = 100.
[770] 4% * 4,000 = 160.
[771] 500 / 10,000 * 100% = 5.00%.
[772] ρ = r. See for some analysis Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, at 1-60.
[773] <50> / 4,000 * 100% = <1.25%>.
[774] On debt financing limitations and their effects under cash flow taxes, see Robin Broadway, Neil Bruce and Jack Mintz, *On the Neutrality of Flow-of-Funds Corporate Taxation*, Economica, New Series, Vol. 50. No. 197 (1983), at 49-61.
[775] See Franco Modigliani and Merton H. Miller, 'The Cost of Capital, Corporation Finance and the Theory of Investment', 48 *The American Economic Review* 261 (1958), at 261-297, and Franco Modigliani and Merton H. Miller, 'Corporate Income Taxes and the Cost of Capital: A Correction', 53 *The American Economic Review* 433 (1963), at 433-443.

The model forwarded in this study, however, excludes risk from the analysis and fixes 'r' on 4%, regarding both the debt and equity provided. It accordingly simplifies reality. This has been done for the sake of simplicity. The point is to illustrate the mechanism, not to argue the normal return rate to be fixed regardless of financing structures, debt-to-equity ratios, and firm earning powers. It should nevertheless be appreciated that any translation from 'r' in the model into a 'proper' interest rate or set of interest rates for tax law design purposes, for instance under an 'allowance for corporate equity' mechanism (see section 6 of this chapter hereunder), would be very difficult if not impossible to achieve. Each amount chosen would operate as a proxy and, in consequence, arbitrarily to some extent.

5.3.4 Operating through interposed subsidiary 'Johnson's Dinghy Sales Subsidiary Co.'

Johnson could very well have chosen to invest in the dinghy sales indirectly, i.e., through an interposed controlled subsidiary. In such a case, Johnson would set up a corporate entity, say 'Johnson's Dinghy Sales Subsidiary Co.', and would make the amounts to be invested available to this subsidiary. The legal title under which these amounts are made available may inconsequentially be debt capital, equity capital or a combination thereof. Economically, the legal structuring of the investment in the dinghy distribution, i.e., directly or indirectly via a controlled subsidiary, is of no relevance. Viz., Johnson ultimately controls things. The return on Johnson's investment, in our example of 6.5%, does not differentiate as a consequence of the legal separation of the dinghy selling activities in a controlled subsidiary.

5.3.5 The alternative business opportunity: (in)direct investment in dinghy distribution business of a third-party

As an alternative to the (in)direct investment in the dinghy selling activities, Johnson could have also invested in the equity capital of a third party. With this it is implied that a minority shareholder's interest is taken on in a participation, a corporate body (in)directly operating a business activity, for instance a dinghy distribution business.

Should such a joint venture in a capital asset yield a return of 6.5%, Johnson, now in the position as co-owner of the corporate body (i.e., a minority interest) and, with that, indirectly of the underlying business activity, would derive a return comprising of the aforementioned two components as well. Johnson would again derive a normal market return of 4% and an economic rent of 2.5%.

It should be noted, however, that this time, it is not Johnson operating the underlying dinghy selling activities. The entrepreneur or economic operator now is the respective participation in which Johnson holds its non-controlling minority shareholding interest, just as Johnson is the entrepreneur in the initial example. That is, he operates the dinghy sales activity itself, directly or indirectly through a controlling shareholder's interest in a subsidiary. When it concerns an investment in a minority shareholding interest, Johnson is merely one in a range of investors/owners, a party participating in a joint venture. This, however, does not entail that Johnson's return to the investment in such a venture, in summary, would alter in comparison with the (in)direct investment in the dinghy selling activities. It remains to equal 6.5%, comprising two distinct components: the opportunity costs of capital (4%) and the excess earnings as derived by the activities performed by the company involved (2.5%).

5.4 Problematic effects under conventional corporate income tax

5.4.1 General remarks

5.4.1.1 Introducing a typical corporate tax into the model

Now let us introduce a tax ('t') into our example. As said, we are in search of a levy which merely taxes Johnson's excess earnings of €100 in an equitable and neutral manner. Today,

under a conventional corporate income tax, this is not the case. Consequently, this reality triggers all kinds of distortions and various inequities.

5.4.1.2 Nominal return to equity

Under their corporate income tax systems, states basically employ the derived nominal return to the invested equity capital as the foundation concept for taxable profit calculation purposes rather than stand-alone business cash flows. Equity mutations with origins in the shareholding relationship, such as outbound dividend distributions and inbound equity contributions, are not recognized for taxable income calculation purposes.

Neither the opportunity costs of capital nor inflation are taken into consideration.[776] Remunerations for the provision of debt capital and (in)tangible capital, nevertheless, are treated distinctively for tax purposes. These are taken into account for taxable profit calculation purposes. Accordingly, for instance, contrary to dividend payments, interest payments as well as leasehold and royalty payments constitute tax-deductible items. Both the remuneration for the provision of the production factor of equity capital and the production factor of enterprise are taken into account for taxable corporate income tax calculation purposes.

5.4.1.3 Realization basis

The attribution of proceeds to tax years occurs under (tax) accounting principles, which typically to a (very) large extent correspond with, if not operate equal to, common business economics and accounting principles (e.g. the reality, matching, realization and prudence principles).[777]

Under the realization principle, proceeds are typically taxed upon realization rather than, for instance, upon payment.[778] Accordingly, accrued yet unrealized income typically remains untaxed, while realized income is taxable, hence, tax-favoring the first over the latter.[779] This entails tax deferral issues in respect of unrealized net accretions of wealth. Notably, tax deferral, i.e., the occurrence and presence of hidden reserves, as well as the spin-off exit taxation issues, may for instance be resolved by adopting fair market or 'mark-to-market' value corporate income tax accounting. Such a modification would enhance the appreciation of the S-H-S concept of income.[780]

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[776] Inflation is currently typically recognized indirectly in taxation, i.e., by annually resetting the tax brackets. This is not further discussed.

[777] As an illustration, reference can be made to the Netherlands, which applies the so-called 'principle of sound business practice', for this purpose. The principle is laid down in Article 8 of the Dutch CITA in conjunction with Article 3.25 of the Dutch IITA 2001. For a brief discussion of the concept, see Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international (*2011), at 447-470.

[778] As the timing of payments generally is irrelevant, the taxable event cannot be delayed by delaying the payments. Notably, under the cash flow taxes analyzed in section 7, such a deferral issue would not be present as all cash flows, both inward bound and outward bound cash flows trigger tax effects. The first would trigger a tax payable, the second a tax refund. Accordingly, it would be of no use to delay payments as that would not only delay the tax liability but also the tax refund of the business partner with whom the business transaction has been arranged.

[779] Accordingly, the theoretical S-H-S concept of income is not implemented to its full extent at this point. For example, most states do not tax capital gains on an accrual basis, but postpone corporate taxation up until the moment that the capital gain has been realized. See OECD Tax Policy Studies, *Fundamental Reform of Corporate Income Tax*, No. 16, OECD, Paris, 2007.

[780] Please note that I do not have a conceptual problem with this. See for a comparison Kevin Holmes, *The Concept of Income; A Multidisciplinary analysis* (2001), at 570. Holmes cites Richard Krever, 'Structural Issues in the Taxation of Capital Gains', 1 *Australian Tax Forum* 164 (1984), at 171, who argues that there is no persuasive reason for favoring the taxpayer who has difficulty finding cash for her taxes because she keeps her income in appreciated assets over the taxpayer who has similar problems because she prefers to consume with all her income rather than pay taxes. Holmes argues that arising liquidity problems could be overcome, for instance, by allowing taxpayers to defer payment of taxes on unrealized net wealth accretions where interest is charged during the deferral period. Such a mechanism may already be found in the international tax regime. An example is the Dutch 'preserved assessment' levied in respect of taxpayers, individuals, having substantial corporate shareholdings in Dutch resident companies, upon their emigration to abroad.

5.4.1.4 Tax depreciation

Common business economics and commercial accounting also employs both the return to equity and fair market value standards for profit calculation.[781] To ascertain that income is taxed when accrued, investments generally are capitalized rather than expensed. Alternatively, tax-deductible depreciation terms, write-offs, amortizations and write downs or impairments become available ('d'). Conceptually, tax depreciation seeks to correspond with true economic depreciation.[782]

However, tax depreciation is often utilized as a fiscal policy instrument as well, and is consequently typically subject to country-specific mutually diverging arbitrary rules and mechanisms.[783] This exacerbates tax deferral issues. In addition, it is common that investments in non-location specific intangible assets are typically tax treated favorably relative to location specific tangible assets.

Tax-deductible losses suffered in a particular tax year generally do not lead to a tax refund, but rather may typically be carried back to (a) previous year(s) or carried forward to (a) subsequent year(s) at their nominal amounts. The absence of tax refunds ascertains revenue so as to avoid exposure to private sector investments risks.

5.4.2 The effects involving a direct investment

5.4.2.1 Assessing the investment returns of 'Ben Johnson Dinghy Selling Company'

Let us return to our taxpayer Johnson and its dinghy business activities. As said, Johnson invests in a dinghy selling project. Assume that the corporate income tax rate equals a linear 25%; progressivity is not considered here merely for the sake of simplicity. Under a conventional corporate income tax, the effects are as follows (fig. 33):

Fig. 33. Johnson's CIT calculation

	Period 1	***Period 2***
Johnson's CIT calculation		
Earnings		
Gross Earnings ('EBITDA')	0	+ 10,500[784]
Aggregate	0	+ 10,500
Costs		
Financing Expenses (interest)	0	– 240[785]
Depreciation	0	– 10,000[786]
Aggregate	0	– 10,240[787]
Tax Levy		
Aggregate (Taxable Amount)	0	+ 260[788]
Tax[*)] (25%)	0	+ 65[789]

[781] Various tax scholars discuss the question of whether and to which extent a convergence of tax accounting principles, rules and concepts and commercial accounting principles, rules and concepts is desirable. And the derivative question of which of these areas and to what extent they should advance in a certain direction; often referred to as '(umgekehrte) Massgeblichkeit'). See on this matter, Wolfgang Schön, 'International Accounting Standards – A "Starting Point" for a Common European Tax Base?', 44 *European taxation* 426 (2004), at 426-440, and Lida Jaatinen, 'IAS/IFRS: A Starting Point for the CCCTB?', 40 *Intertax* 260 (2012, No. 4), at 260-269. Krever and Burns set forth that uniformity between tax and financial accounting may seem desirable. See Lee Burns et al, 'Taxation of Income from Business and Investment', in Victor Thuronyi et al, *Tax Law Design and Drafting* (1998), at Chapter 16. These questions are not further discussed in this study.

[782] Tax depreciation mechanisms typically seek to correspond with the economic lifetime of the respective asset, i.e., the period over which an asset is expected to be of economic use.

[783] For analyses see Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264. The authors demonstrate that various OECD Member States subject location specific assets such as real estate situated within their territories to relatively high effective taxation rates in comparison to mobile production factors – broadening the tax base to that extent to finance statutory tax rate reductions.

[784] $1 + \rho$.

[785] $- \alpha.r$.

[786] $- d$.

[787] $- \alpha.r - d$.

[788] $(500 - 240) + (10{,}000 - 10{,}000) = 260$. Accordingly: $(\rho - \alpha.r) + (1 - d)$.

[789] $0.25 * [(500 - 240) + (10{,}000 - 10{,}000)] = 65$. Accordingly: $t.[(\rho - \alpha.r) + (1 - d)]$.

*) A tax preceded by a '+' sign represents an amount of tax payable.

Johnson's business activities produce the following business cash flows (fig. 34):

Fig. 34. Johnson's Cash Flow Statement

	Period 1	***Period 2***
Johnson's Cash Flow Statement		
Real Transactions ('R')		
Investment	– 10,000[790]	
Gross Return on Investment		+ 10,500[791]
Aggregate	– 10,000[792]	+ 10,500
Financial Transactions ('F')		
Debt Issuance	+ 6,000[793]	
Repayment Principal Amount		– 6,000[794]
Interest Paid		– 240[795]
Aggregate	+ 6,000[796]	– 6,240[797]
Tax Levy		
Tax*) (25%)	0	+ 65[798]
Aggregate	– 4,000[799]	+ 4,195[800]

*) A tax preceded by a '+' sign represents an amount of tax payable.

The net outbound cash flow in period 1 equals €4,000, an amount equal to the equity capital Johnson invested. The transactions in period 1 do not constitute a taxable event under a conventional corporate income tax. The net inbound cash flow in period 2 nevertheless alters in comparison with the no tax environment. Now, the inflow in period 2 equals €4,195. The net post-tax return to the invested equity capital ('v_{CIT}') equals €195, a percentage of 4.875.[801] What does this tell us? The numbers tell us three things (see sections 5.4.2.2, 5.4.2.3 and 5.4.2.4).

5.4.2.2 Average Effective Tax Rates; the 'tax-wedge'

First, it tells us something about the average effective tax rate ('AETR') under a conventional corporate income tax. The AETR is calculated by dividing the tax payable (numerator) by the pre-tax income (denominator).[802] The tax payable to be adopted in the numerator equals €65. With respect to the amount to be adopted in the denominator, the following remarks should be made. Johnson's pre-tax return of €260, as said, comprises of two components. The first component amounting to €100 refers to the excess earnings, the remuneration for the production factor of enterprise. The second component amounting to €160 refers to the normal market return rate (opportunity costs of capital), the remuneration for the equity capital provided. Which of these amounts should be taken into consideration?[803]

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[790] – 1.
[791] 1 + ρ.
[792] – 1.
[793] α.
[794] – α.
[795] – α.r.
[796] α.
[797] – α.(1 + r).
[798] t.[(ρ – α.r) + (1 – d)].
[799] – (1 – α).
[800] (1 – α) + (1 – t).(ρ – α.r) – t. (1 – d).
[801] (4,195 / 4,000) – 1 = 0.04875. Accordingly: v_{CIT} = (1 – α) + (1 – t).(ρ – α.r) – t. (1 – d) / (1 – α) – 1 = (1 – t).[(ρ – r) / (1 – α) + r] – t.(1 –d) / (1 – α).
[802] See Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 73. See also Martin Ruf, 'The Economic Unit of Effective Tax Rates', 3 *World Tax Journal* 226 (2011), at 226-246.
[803] See for a comparison Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, who refer to concerns as to whether it is suitable to find a proper measure of profit to use as the denominator.

Would the pre-tax nominal return to equity, €260, be adopted as denominator for AETR calculation purposes, the outcome would be an AETR equal to 25%.[804] Viz., the post-tax nominal return on the invested equity capital equals 75% of the pre-tax nominal return on the invested equity capital. The difference between the pre-tax return, 6.5%, and the post-tax return, 4.875%, is 1.625%, sometimes referred to as the 'tax-wedge', and is equal to the pre-tax nominal return to equity multiplied by the employed tax rate of, in this case, 25%.[805]

Despite the practice that the AETR calculation as performed here is the one as typically employed, I nevertheless doubt whether the proper amount as a denominator has been adopted. Are we comparing apples and oranges? Perhaps one should just consider business cash flows in this respect. I would favor adopting that approach. Namely, if one recognizes that savings – the remuneration for the provision of capital – should not be taxed under a business income tax as such a tax should merely tax the remuneration for the production factor of enterprise; the normal market rate of return should *a fortiori* also not be taken into account for AETR calculation purposes. Provided that one recognizes that the actual business cash flow derived from the dinghy selling activities, i.e., the earnings exceeding the normal market rate of return which account for a mere €100, the AETR under a conventional corporate income tax exceeds its statutory tax rate as it disregards the opportunity costs of capital for tax calculation purposes. Under that point of reference, i.e., if the pre-tax excess earnings equal to €100 is adopted as the denominator for AETR calculation purposes, the AETR calculation in our example produces an AETR equal to 65%.[806] Accordingly, such an above statutory AETR under a conventional corporate income tax should be considered unfair as it does not reflect economic reality. This holds true also in cases where states tax savings under a portfolio investment income tax *de facto* producing an economic double taxation of savings income.[807]

This being said, moreover, a conventional corporate income tax only produces an AETR equal to 25% (or 65% when employing pre-tax excess earnings as the denominator), in the event that the tax depreciation employed for tax calculation purposes corresponds with economic depreciation.[808] Would tax depreciation and economic depreciation mutually diverge, the wedge between pre-tax and post-tax rates of return would grow bigger or smaller dependent on facts and circumstances causing the AETRs to fluctuate accordingly. If tax depreciation, for instance, would be limited to 95% relative to the economic depreciation, the effective return on Johnson's dinghy sales activity would reduce. In such a case, the tax payable would equal €190,[809] lowering the nominal return to equity rate to 1.75%.[810] Should tax deprecation, for instance under an investment allowance, be 102% relative to the economic depreciation, the effective return on Johnson's dinghy sales activity would increase. In such a case, the tax payable would equal €15,[811] increasing the nominal return to equity rate to 6.125%.[812]

Tax wedge affects investment location decisions

Consequently, divergences between tax depreciation and economic depreciation affect location investment decisions, i.e., the economic operator's decision as to where to produce. This explains the wide range of states adopting a multitude of investment allowances, (accelerated) depreciation allowances or (even) tax holidays in their international tax systems. In today's globalizing economy, this particularly holds true in respect of mobile intangible assets which, as said, typically are treated favorably for tax purposes relative to less mobile tangible assets. The plain and simple reason for states adopting such tax incentives is to attract business operations to their jurisdictions, i.e., the carrots regimes referred to in

[804] 65 / 260 * 100% = 25%.
[805] 6.5% – 4.875% = 0.25 * 6.5%. Accordingly: $v - v_{CIT} = t.[v + (1 - d) / (1 - \alpha)]$.
[806] 65 / 100 * 100% = 65%.
[807] The question as to whether savings should be taxed in the first place, as said, is not considered in this study.
[808] d = 1.
[809] 0.25 * [(500 – 240) + (10,000 – 9,500)] = 190.
[810] (4,070 / 4,000) – 1 = 0.0175.
[811] 0.25 * [(500 – 240) + (10,000 – 10,200)] = 15.
[812] (4,245 / 4,000) – 1 = 0.06125.

Chapter 1.[813] Notably, the tax responsiveness to investment locations is addressed in Chapter 6.

The distortive effects caused by the differences created by states between the 'tax reality' and 'actual (economic) reality' prove distortive and with that non-equitable. Obviously, provided that all other circumstances are equal, a lower AETR in one state relative to the AETR imposed by another state will drive an entrepreneur striving for profit optimization to invest in the first mentioned state. This holds true as income is attributed to taxing jurisdictions by means of origin based profit allocation factors.

It is no secret that states compete with each other to attract business activities. Relatively higher AETRs drive investments abroad. Various studies verify that AETRs affect business decisions as to where to produce.[814] This effect is exacerbated as economic rents produced by multinational firms become increasingly non-location-specific as a consequence of globalization, the internet, and the high mobility of their most valuable resources: the multinational firm's intangibles. Multinationals prove flexible in their decisions as to where to produce and, hence, are able to geographically transfer their income producing resources in response to tax.[815] The relative value of location-specific tangible assets in today's economy, for instance real estate, is on the decline. And with that, the same is true with regard to location-specific rents.

Logical reasoning entails the recognition of states playing a zero sum game. The attraction of business activities to a certain state by means of its tax incentives necessarily triggers mutual spill-over effects. The attraction to one state is necessarily at the cost of another. A favorable tax climate in one state works to the disadvantage of any other state. It has been verified that this triggers tax competition in practice rather than tax cooperation.[816] That is, the provision of even more favorable tax treatment by the other state to 'outsmart' its competitors results in the renowned 'race to the bottom' fuelled by ever-increasing globalization.[817] And this may perhaps entail a zero business income tax (revenue) in the end. Notably, as previously stated, the attribution of profits to taxing jurisdictions is further assessed as an isolated issue in Chapter 6.

[813] See for some analysis and literature references Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.
[814] See for instance Huizinga and Laeven who find evidence in support of profit shifting in Harry Huizinga et al, 'International profit shifting within multinationals: a multi-country perspective', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:260. See also Michael P. Devereux, 'Taxes in the EU New Member States and the Location of Capital and Profit', *Oxford University Centre for Business Taxation Working Paper* 2007:0703, Michael P. Devereux, 'Business taxation in a globalized World', 24 *Oxford Review of Economic Policy* 625, (2008), at 625-638, Michael P. Devereux et al, 'Do countries compete over corporate tax rates?', 92 *Journal of Public Economics* 1210 (2008), at 1210-1235, and Michael P. Devereux et al, 'Taxing Multinationals', *National Bureau of Economic Research Working Paper* 2000:7920.
[815] See Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), at 17-18. See also Ruud A. de Mooij et al, 'An applied analysis of ACE and CBIT reforms in the EU', 18 *International Tax and Public Finance* 93 (2011), at section 3.3.
[816] See Michael P. Devereux, 'Business taxation in a globalized World', 24 *Oxford Review of Economic Policy* 625, (2008), at 625-638 and Michael P. Devereux et al, 'Taxing Multinationals', *National Bureau of Economic Research Working Paper* 2000:7920. Worth mentioning also is Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010. Auerbach notes the steady decline of US corporate tax revenues as a share of national income, as well as the international pressure, also felt in the US, to reduce rates while attracting foreign business activities. Further, see Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), at section 4.2. Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, find support for concluding that tax revenues in corporate income weighted by gross domestic product remained broadly stable. This is not further discussed.
[817] See on this matter, e.g., Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264.

5.4.2.3 Financing discrimination; distorting financing decisions

Second, the numbers forwarded in the cash flow statement above tells us something about the effects of financing decisions. These heavily influence the AETR imposed under a conventional corporate income tax. Taking the returns on the investment in the dinghy sales activity forwarded in the above as a given, the AETR, under a conventional corporate income tax, could vary with a factor of 5 dependent on the manner in which Johnson had financed its investment.

As demonstrated, a conventional corporate income tax taxes the nominal return to equity. Both the excess earnings (€100) and the opportunity costs of capital (€160) are taken into consideration for corporate income tax calculation purposes. These components respectively produce €25 and €40, i.e., an aggregate of €65 payable corporate income tax. Inflation is not taken into consideration.

Had Johnson financed the dinghy sales activity entirely with debt,[818] the conventional corporate income tax would have produced a different tax liability in comparison with the base case scenario. In that event, merely the excess earnings amounting to €100 would have been taxed. The tax payable would have accounted for €25 instead of €65.[819] Accordingly, the tax burden imposed would have dropped significantly. Had Johnson financed the dinghy sales activity entirely with equity,[820] the conventional corporate income tax would have produced a different tax liability in comparison with the base case scenario as well. In that event, the entire return to equity amounting to €500 would have been taxed. The tax payable would have accounted for €125 instead of €65.[821]

Accordingly, 100% debt financing of the investment would have entailed a tax payable of €25, while 100% equity financing would have entailed a tax payable of €125. The AETR imposed varies with a factor of 5 dependent on the question of whether and to what extent Johnson financed its activities with debt or equity. No significant economic differences exist between debt and equity financing (absent gradual risk differentials), as both in the end merely constitute a remuneration for the making available of monetary capital to finance economic activity. The distinctive tax treatment, dependent on the chosen financing arrangements, may accordingly be referred to as a discriminatory property in conventional corporate income tax systems distorting taxpayers' financing decisions ('financing discrimination').

Under a conventional corporate income tax, taxpayers are encouraged to finance investment with as much debt as possible. Seen from that perspective, the corporate income tax system basically subsidizes debt financing relative to equity financing. It encourages taxpayers to take on debt rather than finance business with equity. As this conflicts with the neutrality principle, this financing discrimination provides an inequitable property of a conventional corporate income tax system heavily in need of being resolved.

5.4.2.4 Marginal Effective Tax Rates; distortions at the margin

Third, the numbers forwarded in the cash flow statement above tells us something about the marginal effective tax rate ('METR') under a conventional corporate income tax system. The METR is calculated by measuring the tax burden on an additional unit of pre-tax income.[822]

The non-neutralities induced by the distinctive tax treatment of debt and equity financing appear even more starkly when the corporate income tax's METR is looked into. Suppose that Johnson's investment in the dinghy selling activities would have yielded a return equal to the opportunity costs of capital of, in our example, 4%, i.e., €400.[823] The marginal return on the investment equals its costs. In the case that the remaining facts and circumstances are

[818] $\alpha = 1$.
[819] 0.25 * (500 – 400) + (10,000 – 10,000) = 25.
[820] $1 - \alpha = 1$; $\alpha = 0$.
[821] 0.25 * 500 + (10,000 – 10,000) = 125.
[822] See Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 73.
[823] $\rho = r$.

equal to those in the base case scenario, i.e., Johnson employed €4,000 equity and €6,000 debt to finance its investment, the tax payable on the normal market return rate – the opportunity costs of capital – would equal €40.[824] Accordingly, despite the fact that Johnson's marginal return equals nil, he would be liable to pay tax. Had Johnson financed the dinghy sales activity entirely with debt, the tax payable at the margin would equal nil.[825] 100% equity financing would have produced a tax payable of €100.[826] Hence, the corporate income tax payable at the margin ranges between nil and €100 dependent on Johnson's financing decision.

METRs fluctuate significantly, dependent on whether Johnson financed its marginal investment with debt or equity. Only in the event that Johnson had financed its investment with 100% debt, the METR would equal nil. In each scenario where equity financing plays a role, the METR equals an infinite amount ('∞'). This is caused by the fact that under a conventional corporate income tax system, the opportunity costs of capital are not taken into consideration when calculating the tax payable. This discriminatory tax treatment encourages taxpayers to finance their investments, especially those at the margin, with debt.

The financing discrimination features may even drive taxpayers to choose to finance with debt where they, for one reason or another, would have chosen equity financing in a no tax environment. In my view, this is undesirable. Financing discrimination issues in corporate taxation under conventional corporate income tax system again are seriously in need of being resolved. Some even argue that, since the corporate income tax encourages excessive corporate borrowings, the corporate income tax has contributed to the recent financial and economic crises.[827]

5.4.3 The effects that arise when it involves an (in)direct investment through an interposed controlled subsidiary

5.4.3.1 Assessing the investment returns through interposed subsidiary 'Johnson's Dinghy Sales Subsidiary Co.'

In addition, as previously stated, Johnson could very well have chosen to invest in the dinghy sales activity indirectly, i.e., through an interposed controlled subsidiary, referred to as 'Johnson's Dinghy Sales Subsidiary Co.'

Economically, things would not substantially alter. The investment and its return in our example would remain identical ($1_{sub} = 1$; $\rho_{sub} = \rho$). In this respect, the legal structuring of the investment in the dinghy business, i.e., directly or indirectly via a controlled subsidiary, is of no significance as Johnson controls the undertaking. This, however, is untrue when it concerns the tax effects under a conventional corporate income tax. While ignoring economic reality, states typically maintain the approach of taxing corporate entities on an individual basis, even if these entities belong to a (multinational) firm or group. This 'separate entity approach' or 'separate accounting', has already been thoroughly discussed in Chapter 4. Legal reality is respected for corporate income tax calculation purposes even when it does not correspond with actual (economic) reality.

5.4.3.2 The effects of the deviation between the 'corporate income tax reality' and the 'actual reality' are significant

Intra-firm financing not governed by market forces yet affect tax levels

[824] 0.25 * [(400 – 240) + (10,000 – 10,000)] = 40.
[825] 0.25 * [(400 – 400) + (10,000 – 10,000)] = 0. Cf. Charles E. Mclure, Jr., 'The State Corporate Income Tax : Lambs in Wolves' Clothing', in Henry J. Aaron et al, *The Economics of Taxation* (1980) 327, at 336, following Joseph E. Stiglitz, 'Taxation, Corporate Financial Policy, and the Cost of Capital', 2 *Journal of Public Economics* 1 (1973), at 1-34.
[826] 0.25 * [400 + (10,000 – 10,000)] = 100.
[827] See, for instance, Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010.

The effects of the deviation between the 'corporate income tax reality' and the 'actual reality' are significant. Upon its decision to invest in a dinghy sales activity indirectly, Johnson may randomly decide to make the funds extracted from the capital markets (€4,000 equity capital, €6,000 debt capital) available to its subsidiary in terms of legal titles. Johnson could, for instance, make the funds available to its subsidiary under the exact same legal terms and titles as it has extracted them from the capital market ($\alpha_{sub} = \alpha$; $1 - \alpha_{sub} = 1 - \alpha$; $r_{sub} = r$). This, however, is not a necessity.

As Johnson controls its subsidiary, Johnson has total autonomy in its decisions in this respect. Johnson could make the funds available under each arbitrary legal title or term it finds appropriate ($\alpha_{sub} \neq \alpha$; $1 - \alpha_{sub} \neq 1 - \alpha$; $r_{sub} \neq r$). Viz., the relationship between Johnson and its subsidiary is not governed by market forces where the commercial interests of independent contracting partners are necessarily opposing. Yet, this economically arbitrary legal reality created between Johnson and 'Johnson's Dinghy Sales Subsidiary Co.' is, in principle, respected for corporate income tax calculation purposes. Moreover, the tax regimes applied to Johnson and its subsidiary are not necessarily identical ($t_{sub} \neq t$; $d_{sub} \neq d$). Obviously, in a globalizing economy, this dichotomy provides various tax planning opportunities.

As conventional corporate income tax systems typically recognize corporate entities as separate taxpayers, even when they are part of the same multinational firm, effects now are recognized at two levels. First, they are recognized at the level of Johnson's Dinghy Sales Subsidiary Co. in regards to the returns on the investment in the dinghy selling activities. Second, they are recognized at the level of Johnson upon the repatriation of the post-tax earnings.

To explore the effects of this in terms of actual tax burdens, let us first assume that Johnson makes the funds available to its subsidiary under the exact same legal terms and titles as it has extracted them from the capital markets. Moreover, let us assume that the post-tax returns, as derived by Johnson's Dinghy Sales Subsidiary Co., immediately are repatriated to Johnson, e.g. by means of a dividend distribution (or alternatively assume mark-to-market value corporate income tax accounting will apply).

Under a conventional corporate income tax, the tax calculations at the level of Johnson's Dinghy Sales Subsidiary Co. are identical to those as set forth in the previous section 5.4.2. These are as follows (the repetition of the table is for the sake of convenience– fig. 35):

Fig. 35. Johnson's Dinghy Sales Subsidiary Co.'s CIT Calculation

	Period 1	***Period 2***
Johnson's Dinghy Sales Subsidiary Co's CIT Calculation		
Earnings		
Gross Earnings ('EBITDA')	0	+ 10,500
Aggregate	0	+ 10,500
Costs		
Financing Expenses (interest)	0	– 240
Depreciation	0	– 10,000
Aggregate	0	– 10,240
Tax Levy		
Aggregate (Taxable Amount)	0	+ 260
Tax*) (25%)	0	+ 65

*) A tax preceded by a '+' sign represents an amount of tax payable.

The repatriation of the post-tax earnings constitutes a taxable event at the level of Johnson. If dividend taxation is assumed to be absent – i.e., dividend taxation is non-existent, a dividend tax exemption applies, or the dividend tax is fully creditable against corporate income tax – the effects are as follows (fig. 36):

Fig. 36. Johnson's CIT Calculation

	Period 1	***Period 2***
Johnson's CIT Calculation		

Earnings		
Gross Earnings ('EBITDA')	0	+ 10,435[828]
Aggregate	0	+ 10,435
Costs		
Financing Expenses (interest)	0	– 240[829]
Depreciation	0	– 10,000[830]
Aggregate	0	– 10,240[831]
Tax Levy		
Aggregate (Taxable Amount)	0	+ 195[832]
Tax*) (25%)	0	+ 48,75[833]

*) A tax preceded by a '+' sign represents an amount of tax payable.

Johnson's business activities produce the following business cash flows. Notably, the intra-firm cash flows, i.e., those between Johnson and Johnson's Dinghy Sales Subsidiary Co., are ignored for their lack of economic substance (fig. 37):[834]

Fig. 37. Johnson's Cash Flow Statement

	Period 1	***Period 2***
Johnson's Cash Flow Statement		
Real Transactions ('R')		
Investment	– 10,000[835]	
Gross Return on Investment		+ 10,500[836]
Aggregate	– 10,000	+ 10,500
Financial Transactions ('F')		
Debt Issuance	+ 6,000[837]	
Repayment Principal Amount		– 6,000[838]
Interest Paid		– 240[839]
Aggregate	+ 6,000	– 6,240[840]
Tax Levy		
Tax Johnson's Dinghy Sales Subsidiary Co*)	0	+ 65[841]
Tax Johnson*)	0	+ 48.75[842]
Aggregate	0	+ 113.75[843]
Aggregate	– 4,000[844]	+ 4,146.25[845]

*) A tax preceded by a '+' sign represents an amount of tax payable.

[828] 10,500 – 65 = 10,435. Accordingly: $1 + \rho + t_{sub}.[(\rho - \alpha_{sub}.r_{sub}) + (1 - d_{sub})]$.
[829] $- \alpha.r$.
[830] – d. For simplicity reasons, it is assumed that $d = d_{sub}$.
[831] $- \alpha.r - d$.
[832] (500 – 240) + (10,000 – 10,000) – 65 = 195. Accordingly: $(\rho - \alpha.r) + (1 - d) + t.[(\rho - \alpha_{sub}.r_{sub}) + (1 - d_{sub})]$.
[833] 0.25 * [(500 – 240) + (10,000 – 10,000) – 65] = 48.75. Accordingly: $t.\{(\rho - \alpha.r) + (1 - d) + t_{sub}.[(\rho - \alpha_{sub}.r_{sub}) + (1 - d_{sub})]\}$.
[834] This supplementary assumption seems justified as intra-group transactions and their equivalent intra-group cash flows necessarily lack economic substance. See for a comparison, commercial accounting standards, who call for commercial consolidation of the group companies' stand-alone records. See, for instance, IAS 27.
[835] – 1.
[836] $1 + \rho$.
[837] α.
[838] $- \alpha$.
[839] $- \alpha.r$.
[840] $- \alpha.(1 + r)$.
[841] $t.[(\rho - \alpha_{sub}.r_{sub}) + (1 - d_{sub})]$.
[842] $t.\{(\rho - \alpha.r) + (1 - d) + t.[(\rho - \alpha_{sub}.r_{sub}) + (1 - d_{sub})]\}$.
[843] 65 + 48.75 = 113.75. Accordingly: $t_{sub}.[(\rho - \alpha_{sub}.r_{sub}) + (1 - d_{sub})] + t.\{(\rho - \alpha.r) + (1 - d) + t_{sub}.[(\rho - \alpha_{sub}.r_{sub}) + (1 - d_{sub})]\}$. Under the assumptions $t_{sub} = t$; $\alpha_{sub} = \alpha$; $1 - \alpha_{sub} = 1 - \alpha$; $r_{sub} = r$; $d_{sub} = d$ this formula may alternatively be referred to as: $[1 - (1 - t)^2].[(\rho - \alpha.r) + (1 - d)]$. The mathematical involution with the characteristic 2 illustrates the tax cascading effects. Under the same assumptions, the aggregate tax impost upon the inter-positioning of an x-amount corporate entities may be calculated by reducing the return on the investment with a figure equal to the taxable corporate income tax base multiplied with a factor $(1 - t)^x$, whereby x represents the number of interposed corporate entities. Accordingly: $[(\rho - \alpha.r) + (1 - d)] - \{[(\rho - \alpha.r) + (1 - d)].(1 - t)^x\}$. The mathematical involution with characteristic x illustrates the tax cascading effects under the separate entity approach.
[844] $- (1 - \alpha)$.
[845] Under the assumptions $t_{sub} = t$; $\alpha_{sub} = \alpha$; $1 - \alpha_{sub} = 1 - \alpha$; $r_{sub} = r$; $d_{sub} = d$, accordingly: $(1 - \alpha) + (1 - t)^2.(\rho - \alpha.r) - [1 - (1 - t)^2].(1 - d)$. The gross investment return, while recognizing the aggregate tax impost upon the inter-positioning of an x-amount corporate entities may be calculated by multiplying the taxable corporate income tax base with a factor $(1 - t)^x$, whereby x represents the number of interposed corporate entities. Accordingly: $(1 - \alpha) + (1 - t)^x.(\rho - \alpha.r) - [1 - (1 - t)^x].(1 - d)$.

Introducing separate accounting; additional effects

What are the additional effects under the separate entity approach? In comparison with those in the case of a direct investment, two additional effects arise in the case of an indirect investment through a subsidiary.

Tax cascading / multiple taxation

First, in addition to the already acknowledged effect that the tax recognizes the nominal return to equity for tax calculation purposes rather than the mere excess earnings, the separate entity approach causes tax cascading or economic multiple taxation when a multitude of corporate entities are being employed. The tables clearly demonstrate that the return to equity amounting to €260 is subject to tax cascading. Johnson's Dinghy Sales Subsidiary Co. is liable to pay €65 tax. Upon the post-tax profit repatriation, Johnson is subsequently liable to pay €48.75 tax. The aggregate amount of tax due is €113.75. The net outbound (economically substantive) cash flow in period 1 equals €4,000, an amount equal to the invested equity capital. Again, the transactions in period 1 are not considered to constitute a taxable event under a conventional corporate income tax. The net inbound cash flow in period 2 nevertheless alters in comparison with the direct investment under a conventional corporate income tax. Now, the inflow in period 2 equals €4,146.25. The net return to the invested equity capital ('v_{CIT}^{2}') equals €146.25, a percentage of 3.656 (instead of 4.875 in the case of a direct investment in the dinghy sales activity).[846] Under a 25% tax rate, each additional interposed subsidiary would cause the post-tax return rate to drop with a factor of 0.75.[847] This significant decrease in post-tax investment returns, as caused by an increase of the AETR upon the inter-positioning of corporate entities, obviously distorts costs and prices. It also interferes with decisions, for instance on the choice of legal form. This is both inequitable and non-neutral and, therefore, unfair (see also Chapters 2 and 4).

The occurrence of economic double taxation or tax cascading as caused by the adoption of the separate entity approach is a well-known property of the conventional corporate income tax. Tax legislators in various states recognize these distorting effects. It inspired many to try to remedy them through the adoption of, often technically complex, double tax relief measures. Examples of these are the participation exemption or indirect (imputation) credit regimes. These regimes are regularly adopted in conjunction with the application of a 0% dividend tax rate or dividend tax exemption with respect to intra-group dividend distributions. Participation exemption regimes exclude the proceeds from equity interests from the taxable base at the level of the shareholder, who in this case is Johnson. Indirect credit regimes provide for a mechanism enabling taxpayers – shareholders – to credit the underlying corporate income tax that is levied at the level of the corporate bodies in which they hold their shareholding interests against the corporate income tax that is levied on the (grossed-up) proceeds from these equity investments. The European Union Parent Subsidiary Directive, requiring the Member States to adopt either an exemption mechanism or an indirect credit mechanism with respect to inter-company dividend distributions – accompanied with a dividend withholding tax exemption – can be mentioned in this respect as well. The operation of these regimes is discussed in section 5.4.4.

Recognition of intra-group transactions / arbitrary profit shifting

Second, under the separate entity approach, as said, intra-group transactions are recognized for corporate income tax calculation purposes. Johnson may randomly decide to make the funds extracted from the capital markets available to its subsidiary in terms of legal titles. As

[846] (4,146.25 / 4,000) – 1 = 0.03656. Under the assumptions $t_{sub} = t$; $\alpha_{sub} = \alpha$; $1 - \alpha_{sub} = 1 - \alpha$; $r_{sub} = r$; $d_{sub} = d$, accordingly: $v_{CIT}^{2} = (1 - \alpha) + (1 - t)^{2}.(\rho - \alpha.r) - [1 - (1 - t)^{2}] . (1 - d) / (1 - \alpha) - 1 = (1 - t)^{2}.[(\rho - r) / (1 - \alpha) + r] - [1 - (1 - t)^{2}].(1 - d) / (1 - \alpha)$.

[847] For instance, the post-tax return rate on the investment upon the inter-positioning of 3 corporate entities, 'v_{CIT}^{3}', would equal 3.656% * 0.75 = 2.74%. Under the forwarded assumptions (i.e., $\alpha_{sub} = \alpha$; $1 - \alpha_{sub} = 1 - \alpha$; $r_{sub} = r$; $d_{sub} = d$), the post-tax return rate upon the inter-positioning of an x-amount corporate entities may be calculated by referring to the formula: $v_{CIT}^{x} = (1 - \alpha) + (1 - t)^{x}.(\rho - \alpha.r) - [1 - (1 - t)^{x}].(1 - d) / (1 - \alpha) - 1 = (1 - t)^{x}.[(\rho - r) / (1 - \alpha) + r] - [1 - (1 - t)^{x}].(1 - d) / (1 - \alpha)$.

these legal titles are recognized for corporate income tax calculation purposes, this reality, i.e., in conjunction with the aforementioned financing discrimination feature in the conventional corporate income tax, enables Johnson to *de facto* arbitrarily transfer its taxable base between itself and its subsidiary. Viz., Johnson does not necessarily need to make the funds available to its subsidiary under the exact same legal terms and titles as he obtained them from the capital market ($\alpha_{sub} = \alpha$; $1 - \alpha_{sub} = 1 - \alpha$; $r_{sub} = r$).

Basically, two scenarios, or a combination thereof, become available. Johnson could decide to finance its subsidiary completely with equity (*scenario 1*) or completely with debt (*scenario 2*).

> *Scenario 1*. Johnson finances its subsidiary completely with equity ($\alpha_{sub} = 0$; $1 - \alpha_{sub} = 1$). In terms of effective tax burdens imposed, this scenario would turn out less favorably in comparison with the effects under a direct investment in the dinghy distribution business. The tax payable at the level of Johnson's Dinghy Sales Subsidiary Co would equal €125.[848] Upon the repatriation of the post-tax earnings, which in this scenario equals €375,[849] Johnson would be liable to pay an additional tax at an amount of €33.75.[850] An aggregate tax liability of €158.75 and an AETR of 61.1%[851] (or 158.75% to the extent excess earnings are employed as the denominator).[852] The net post-tax nominal return to equity would equal €101.25, a percentage of 2.53 (instead of the aforementioned 4.875% in the case where Johnson invests in the dinghy selling activities directly).[853]
>
> *Scenario 2*. Johnson finances its subsidiary completely with debt ($\alpha_{sub} = 1$; $1 - \alpha_{sub} = 0$). If Johnson makes the funds withdrawn from the capital market available to its subsidiary under an interest bearing loan agreement, for instance a loan carrying interest at a rate of 5% ($r_{sub} \neq r$), the tax burden imposed would decrease substantially. Due to the recognition of, in principle, a tax-deductible interest expense of €500 (0.05 * 10,000) at the level of Johnson's Dinghy Sales Subsidiary Co., its tax payable would equal nil.[854] Johnson however would be liable to pay tax on the interest receipts. The taxable base would equal €260[855] on which €65 tax becomes due.[856] That is, an aggregate tax of €65 and an AETR of 25%[857] (or 65% to the extent that excess earnings are employed as the denominator).[858] The net post-tax rate of nominal return to equity would equal €195, a percentage of 4.875, which is equal to the investment return in the case that Johnson would invest in the dinghy selling activities directly.[859]

This example makes apparent once again that conventional corporate income taxation provides an incentive to finance subsidiaries with as much of intra-group debt as possible against interest rates that are as high as possible. The phenomenon is typically referred to as 'thin capitalization'. This incentive to finance subsidiaries with debt occurs in addition to the debt financing incentives mentioned in the above.

So, conventional corporate income tax systems provide for an additional incentive to finance operational subsidiaries with debt to transfer taxable profits within the group to, in this case, the shareholder. Is this problematic, for instance in terms of tax revenues to be collected? Apart from the initial financing discrimination issues already explored earlier, the answer is in the negative, provided that all investment and business activities occur within the same taxing

[848] 0.25 * 500 + (10,000 – 10,000) = 125.
[849] 500 – 125 = 375.
[850] 0.25 * (375 – 240) = 33.75.
[851] 158.75 / 260 * 100% = 61.1%.
[852] 158.75 / 100 * 100% = 158.75 %.
[853] (4,101.25 / 4,000) – 1 = 0.02531.
[854] 0.25 * (500 – 500) + (10,000 – 10,000) = 0.
[855] 500 – 240 = 260.
[856] 0.25 * 260 = 65.
[857] 65 / 260 * 100% = 25%.
[858] 65 / 100 * 100% = 65%.
[859] (4,195 / 4,000) – 1 = 0.04875.

jurisdiction ($t_{sub} = t$). In such a case, all that happens is that the tax now is collected from another group company rather than from the respective operational subsidiary.

Taking things cross-border; the arbitrage risks revealed

The answer to this question, however, is in the affirmative in the case where the investment and business activities do not occur within the same taxing jurisdiction but in a cross-border context ($t_{sub} \neq t'$). In such a case, the financing discrimination issues are starkly exacerbated as a consequence of the employed separate entity approach. Please allow me to elaborate on the matter hereunder.

In a cross-border scenario, the transfer of taxable profits from, in this case, the subsidiary to its shareholder simultaneously entails a transfer of its taxable base – and tax revenue accordingly – from one tax jurisdiction to another. If the group entity / creditor operates in a taxing jurisdiction other than the state in which the group entity / debtor operates, the latter sees its tax revenues decrease due to the tax deductible intra-group interest expense. If the creditor operates from a relatively lower tax ($t' < t_{sub}$) or even non-tax jurisdiction ($t' = o$) jurisdiction, the overall effective tax burden may decrease significantly as a consequence of the tax deductible interest expense in one jurisdiction not being compensated with a taxable interest receipt in the other. Were Johnson, for instance, to reside for tax purposes in a tax jurisdiction exempting the respective interest receipts, the overall tax burden imposed on Johnson and its subsidiary for the investment's return would be nil. Notably, that would be in addition to the recognized inter-jurisdictional tax revenue transfer.

Such a loophole may, for instance, be caused by beneficial tax regimes, e.g. group financing regimes, in place in the state in which the creditor undertakes its (intra-)group financing activities. This is not the only situation, however. Similar effects may occur when the respective taxing systems mutually diverge (disparities). Examples are mutual differences in the qualification and/or interpretation of facts and circumstances for corporate tax purposes: one state considers an income item, for example, to be a taxable/deductible interest expense, the other state considers it to be a non-deductible/exempt dividend distribution ($\alpha \neq \alpha'$; $1 - \alpha \neq 1 - \alpha'$).[860] Such disparities cause the well-known hybrid income mismatch issues. Other examples are mutual differences in the classification of legal entities for corporate tax purposes: the respective states concerned link up with different legal entities to identify the respective taxable entities ($_{sub} \neq _{sub}'$). Such disparities cause the well-known hybrid entity mismatch issues.

It is no secret that these elements and features of conventional corporate income tax systems are employed in practice for one's individual benefit, i.e., both by well-advised multinational groups of companies as well as nation states, the latter, for example, by means of beneficial tax regimes introduced to attract economic activities. Notably, taxable profit transferring possibilities are not limited to intra-group financing arrangements. Theoretically, this is possible by means of any intra-group transaction; it is just easiest to achieve it by means of intra-group financing arrangements. All that is required is a loan agreement; basically, a pen, a piece of paper, and a (tax) lawyer. Of particular relevance in this respect, in my view, is the recognition that the possibilities to transfer the corporate income tax base across the globe accordingly are principally infinite.

States obviously consider the outbound shift of taxable corporate profits, typically referred to as tax base erosion, problematic. This is particularly problematic to the extent that it concerns their domestic taxable base. Foreign tax base erosion is sometimes considered less relevant. As a consequence, a variety of counter measures can be found in the states' international tax

[860] See on this matter, OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing, 12 February 2013, OECD, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, 19 July 2013, OECD, OECD Committee on Fiscal Affairs, *Public Discussion Draft BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Recommendations for domestic laws), 19 March 2014 – 2 May 2014*, OECD Publishing, Paris, 19 March 2014, OECD, OECD Committee on Fiscal Affairs, *Public Discussion Draft BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Treaty Issues), 19 March 2014 – 2 May 2014*, OECD Publishing, Paris, 2014, and OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Neutralising the effects of hybrid mismatch arrangements,* OECD Publishing, Paris, 16 September 2014.

systems to tackle such profit shifting possibilities. Common, nevertheless, are intra-group interest deduction limitation regimes in all kinds of variations, as well as limitations in the application of double tax relief mechanisms. The measures taken in response to a particular newly developed tax base erosion scheme often has the characteristics of an *ad hoc* correction mechanism. A range of those have already been touched upon in the previous Chapter 4. In response to such a correction mechanism, multinational firms, or at least their advisers, develop other variations to erode the corporate income tax base triggering, yet again, the adoption of *ad hoc* correction mechanisms, this time technically somewhat more complex.

The image of a merry-go-round of repeating tax erosion schemes and subsequent correction measures comes to mind. However, as the underlying features in corporate taxation remain untouched, i.e., the nominal return to equity tax base combined with the separate entity approach, the consequence of states' responses is a staggering and ever expanding body of tax legislation. That is, a body of legislation, which becomes increasingly more technical and complex upon each bill that passes parliament. The result is a continuous generation of non-solutions and perhaps even chaos in the end.

Moreover, states commonly adopt regulations in their tax systems requiring affiliated corporate entities / taxpayers to establish their intra-firm legal arrangements as though they are unrelated (separate accounting under the arm's length principle). In our *scenario 2*, i.e., the case in which Johnson grants a loan carrying interest at a 5% rate, application of the arm's length principle would entail that the interest would be capped at 4% for corporate income tax calculation purposes – note that for the sake of convenience, it is assumed that the 100% debt financing would be acknowledged for corporate income tax calculation purposes under the separate accounting / arm's length pricing model. Viz., in the base case, a 4% interest is considered the normal market rate of return. As a consequence of this, the taxable corporate income at the level of Johnson's Dinghy Sales Subsidiary Co. would equal €100 (instead of nil).[861] The tax liability would amount to €25,[862] leaving €75 post-tax earnings. The repatriation of the €75 post-tax earnings would entail a taxable event at the level of Johnson, which is typically eligible for economic double tax relief. Together with the interest receipt of (now) €400 and the tax-deductible interest expense of €160, Johnson's taxable income would equal €235.[863] This triggers a tax liability amounting to €58.75.[864] Consequently, economic double taxation with respect to the underlying subsidiary's income of €100 emerges – i.e., €25 tax at the level of the subsidiary and upon repatriation, and €18.75 tax at the level of Johnson. As this proves distortive, as previously stated, a subsequent double tax relief mechanism typically becomes available.

One may ask why. To be honest, I do not know. It seems that tax legislators fail to recognize the underlying causes of these problems in the system. In a globalizing economy, problems already arising due to the finance discrimination worsen dramatically under the separate entity approach. These problems cannot be resolved by means of *ad hoc* correction mechanisms, such as (intra-group) interest deduction limitations or the re-qualification for tax calculation purposes of (intra-group) debt into (intra-group) equity (e.g., regarding subordinated profit participating loans issued under terms exceeding, say, 20 years) or vice versa (e.g., regarding redeemable preference shares).[865] This issue has been touched upon for illustration purposes in Chapter 4 as well. As argued, the first step in resolving the matter lies in the abolishment of the separate entity approach.

[861] 500 – 400 = 100.
[862] 0.25 * 100 = 25.
[863] 75 (dividends received) + 400 (interest received) – 240 (interests paid) = 235.
[864] 0.25 * 235 = 58.75.
[865] For an overview of the qualification of profit participating loans in international taxation, particularly the US, Germany and Denmark, reference is made to Jakob Bundgaard et al, 'Profit-Participating Loans in International Tax Law', 38 *Intertax* 643 (2010), at 643 – 662.

5.4.3.3 Tax consolidation remedies

As set forth in Chapter 4, a group of affiliated corporate entities, in our example Johnson and Johnson's Dinghy Sales Subsidiary Co., should be treated as a single taxpayer as they constitute a single economic entity. This can be achieved by means of tax consolidation, i.e., consolidation in a manner technically akin to typical commercial profit accounting consolidation. All intra-group transactions would be eliminated for corporate income tax calculation purposes. The effect of adopting such an approach is that the tax cascading effect does not occur. The post-tax nominal return to equity would not alter upon the inter-positioning of corporate entities. The return would remain exactly the same as the return in the case where Johnson invests in the dinghy distribution business directly. The post-tax return rate would equal 4.875% regardless of the manner in which the undertaken investment activities are legally structured.

Economic double tax relief mechanisms would become redundant as the issue, economic double taxation, would not arise in the first place. The same holds true in respect of the intra-group interest deduction limitations. As the separate entity approach would be let go, intra-group transactions would not be recognized for corporate income tax calculation purposes. Consequently, such transactions would no longer, *a priori*, pose tax base erosion hazards.

Notably, moreover, as set forth in Chapter 3, double tax relief with respect to cross-border business operations may be granted in a neutral and equitable manner under the Dutch-style juridical double tax relief mechanism elaborated upon in the above: the credit for domestic tax attributable to foreign income method. Notably, issues regarding the way in which the geographical attribution of tax base across taxing jurisdictions should occur are dealt with in isolation in Chapter 6.

In summary, tax consolidation would entail that we are back to the effects under a conventional corporate income tax in case of a direct investment, i.e., the point at which we started in section 5.4.2. The additional issues created under the recognition for corporate income tax purposes of the separate entity approach regarding indirect investments in controlled subsidiaries have been resolved conceptually.

5.4.4 The effects involving an indirect investment in a non-controlled participation

5.4.4.1 General remarks

This brings us to the effects in the case of an investment in the equity capital of a third party, i.e., the investment in a non-controlled participation. This issue has not yet been dealt with in this study. Where the additional problems triggered by the separate entity approach could be resolved relatively easily by means of tax consolidation, i.e., to the extent that it concerns a group of affiliated entities, the opposite is true where it concerns investments in the equity capital of a third party.

As said, as an alternative to the (in)direct investment in the dinghy sales activity, Johnson alternatively could have invested in the equity capital of a third party, i.e., a minority shareholder's interest in a participation, i.e., a corporate body operating a business activity, for instance a dinghy distribution business.

'Just' tax cascading issues

The distortions that emerge in the case of an indirect investment in a non-controlled participation seem limited to the economic double taxation of the underlying business income. Profit shifting threats as recognized in the previous section 5.4.3 do not seem to arise, or at least, arise to a far lesser extent. This can be explained by pointing at the different circumstances in these cases. The shareholder does not have a controlling interest in its participation. Our shareholder Johnson now has to deal with its joint venture partners, other shareholders, i.e., third parties. The shareholding does not provide a decisive influence to steer the underlying business activities. Johnson plainly lacks the economic power. Consequently, contrary to the intra-group scenarios forwarded in section 5.4.3, economically,

the shareholder and the participation are separate economic entities. It may be acknowledged that the arbitrage in intra-group transactions does not emerge, at least not significantly, in respect of transactions between shareholder and participation; particularly if the profit allocation operates neutrally (see Chapter 6).

As the shareholding does not provide the holder with sufficient economic power to steer the underlying business affairs in such cases, it may be considered fair to say that, at least to some extent, the economic entities involved are mutually sufficiently independent. Commercial interests do not necessarily overlap. This mutually independent third party relationship between shareholder and participation, to a larger extent, guarantees that the undertaken legal transactions are directed by market forces, which may be appreciated for corporate income tax calculation purposes.

Notably, this does not mean that the core financing discrimination issues as set forth in the above section 5.4.2 do not arise. This issue also emerges as regards to financing arrangements between shareholder and participation. Incentives to finance activities with debt remain in place. The separate entity approach, however, does not exacerbate them. The question as to how to resolve the underlying financing discrimination issue should therefore be seen in isolation as having little to do with distortions that emerge due to the adoption of the separate entity approach. The financing discrimination issue is dealt with in isolation in the subsequent sections.

Let us return to the question as to how to resolve the tax cascading effects, i.e., economic double taxation regarding investments in non-controlled participations. In the event Johnson decides to invest in a minority shareholding, the economic double taxation effects are essentially comparable to those as set forth in the previous section 5.4.3 as regards to the indirect investment in an underlying business activity through a subsidiary. This holds true regardless of the fact that the investment and its return do not necessarily need to be the same ($1_{sub} \neq 1$'; $\rho_{sub} \neq \rho$') since shareholder and participation constitute separate economic entities.

As regards Johnson's indirect investment in a minority shareholding, economic double taxation arises with respect to the underlying participation's business income to the extent that it can be attributed to the relative volume of Johnson's shareholders' interest. In other words, economic double taxation arises to the extent that Johnson's participation issued equity capital to Johnson ('*pro rata parte* effect'). Hence, the double taxation varies directly proportional to the volume of the shareholders' interest. [866] The distortive economic double taxation comprises of two components: the tax levied at the level of the participation, 'component I',[867] and the tax levied at the level of the shareholder, 'component II'. [868]

5.4.4.2 Mitigating tax cascading: participation exemption and indirect credit regimes operate inequitably

With the absence of a decisive influence, the tax consolidation of non-controlled participations does not seem appropriate. Let us therefore look at the economic double tax relief mechanisms currently found in the international tax regime, i.e., the aggregate of states' international tax systems. The international tax regime basically provides for two mechanisms, both adopted to achieve single taxation:

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[866] The double taxation comprises of two components. That is, the tax levied at the level of the participation, proportional to the shareholder's shareholding interest, 'component I', and the tax levied at the level of the shareholder, 'component II'. If 'P' represents the scope of the shareholders interest, whereby $0 < P \leq 1$, the formula referred to in footnote 843 alters as follows. Component I corresponds with the formula component $P.t_{sub}.[(\rho_{sub} - \alpha_{sub}.r_{sub}) + (1_{sub} - d_{sub})]$. Component II corresponds with the formula component $t.\{(\rho - \underline{\alpha.r}) + (1 - d) + P.t_{sub}.[(\rho_{sub} - \alpha_{sub}.r_{sub}) + (1_{sub} - d_{sub})]\}$. The aggregate ('$\sum$') of components I and II, $P.t_{sub}.[(\rho_{sub} - \alpha_{sub}.r_{sub}) + (1_{sub} - d_{sub})] + t.\{(\rho - \alpha.r) + (1 - d) + P.t_{sub}.[(\rho_{sub} - \alpha_{sub}.r_{sub}) + (1_{sub} - d_{sub})]\}$, accordingly, reflects the tax cascading effects in the event of an investment in a non-controlled participation. Note that the underlined component $-\underline{\alpha.r}$ reflects the need to address the potential risk of creating a 'Bosal Loophole', referred to in the following paragraphs.

[867] As said, element I corresponds with the formula component $P.t_{sub}.[(\rho_{sub} - \alpha_{sub}.r_{sub}) + (1_{sub} - d_{sub})]$.

[868] As said, element II corresponds with the formula component $t.\{(\rho - \alpha.r) + (1 - d) + P.t_{sub}.[(\rho_{sub} - \alpha_{sub}.r_{sub}) + (1_{sub} - d_{sub})]\}$.

A. a base exemption mechanism, typically referred to as the participation exemption, and;
B. an indirect credit mechanism, sometimes referred to as 'imputation credit' or 'participation credit'.

Ad A. The application of a base exemption for economic double tax relief purposes entails that the investment in the respective participation is disregarded for corporate tax calculation purposes. The proceeds from such an equity interest are excluded from the taxable base at the level of the shareholder.[869] Consequently, taxation to that extent only occurs at the level of the respective participation.

Two types of problems may be associated with a participation exemption mechanism, i.e., problems in its design as well as conceptual flaws in the mechanism's operation.

Flaws in design

First, participation exemption regimes may not be designed consistently. Typically, states exempt the gross proceeds from a participation such as dividends and capital gains from the taxable base. They often fail, however, to exempt economically related expenses, such as financing expenses, from that taxable base in conjunction accordingly.[870] The consequence of such an inconsistency is an occurring mismatch between exempt profits and tax-deductible expenses, thereby exempting the gross-proceeds rather than the net proceeds from the taxable base.[871]

The issue has sometimes been referred to in tax practice as the 'Bosal Loophole' paraphrasing the Court of Justice's ruling in the renowned Bosal case.[872] The issue has also briefly been touched upon for illustration purposes in Chapter 4, section 4.5.1.3; Ad. 3. Worth mentioning at this point is the following: While the issue as referred to in Chapter 4 concerns a mismatch between exempt underlying business gross-profits derived by group companies and tax-deductible expenses occurred upon the financing of the underlying business activities ('look-through-variation'), the matter regarding participations concerns a mismatch between exempt proceeds from participations at the shareholder's level on the one hand and tax-deductible expenses economically related to the financing of the equity investments on the shareholder's level on the other hand ('non-look-through-variation'). Nevertheless, beside the (non-)look-through-variation, substantially, there is no conceptual difference between the mismatches themselves. Both concern a divergence between an exempt 'plus' and a tax-deductible 'minus'.

Also noteworthy, for instance, the European Commission's proposal for a Common Consolidated Corporate Tax Base (CCCTB) shows evidence of embracing a gross-based

[869] This should occur by crossing out element II from the formula, i.e., the component $(\rho - \alpha.r) + (1 - d) + P.t_{sub}.[(\rho_{sub} - \alpha_{sub}.r_{sub}) + (1_{sub} - d_{sub})]$.
[870] The flaw arises when the component ρ is crossed out from the formula, while the component – α.r is kept in. Accordingly, an imbalance arises between exempt proceeds 'ρ' and tax-deductible expenses '– α.r'. The imbalance or mismatch is referred to as the 'Bosal Loophole'. The component '– α.r' illustrates the effect.
[871] See for a comparison Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008),
at 714: *"the issue here is that the basic structure of the international tax system for multinational companies is close to a source-based tax for equity-financed investment, but a corporate-residence based tax for debt-financed investment. It is hard to think of a sensible economic rationale for this practice, especially when the finance provided is internal to the multinational company. (…) if the basic aim of the tax system is to tax profit arising in the UK, then, in principle, relief should only be given for interest payments made by the parent to the extent that the underlying borrowing was used to finance activities which took place in the UK. Conversely, if interest relief is not granted for payments for borrowing funds used to finance foreign activity, then there is no clear rationale for taxing interest received from foreign affiliates. Exempting foreign source interest receipts from taxation would be a radical departure from the international norm, but one which is implied by the principle that only economic activity taking place in the jurisdiction should be taxed."*
[872] See Court of Justice, case C-168/01 (*Bosal*). In this case, the court ruled that a former tax provision in the Netherlands' international tax system that subjected a deduction of interest expenses related to the financing of a participation to the requirement that the participation derives Dutch-source taxable profits is incompatible with European Union law.

exemption regarding shareholding proceeds, while allowing the taxpayers involved to deduct related financing expenses from the tax base. Briefly put, as it neglects to exempt the net proceeds, i.e., to also exempt the related financing expenses involved from the tax base, the CCCTB also produces a 'Bosal Loophole'.[873]

This issue of a technical nature may be resolved with relative ease by adopting an exemption mechanism which exempts the net proceeds from the tax base, a net-participation exemption mechanism, accordingly exempting the related interest expenses as well.[874] A functional and factual analysis may be performed to identify the relevant earnings and expenses.[875]

Conceptual flaws

Second, the adoption of a base exemption mechanism, and with that also the application of a participation exemption regime, triggers a conceptual problem. As the proceeds are exempt from the taxable base, losses suffered from an investment in a minority shareholding are also exempt, i.e., non-tax-deductible, despite the reality that such losses suffered are commercially real.

As a compensatory measure, some states, such as the Netherlands, allow taxpayers – shareholders – to deduct final losses realized at the level of the shareholding company upon the liquidation of its (foreign) participation under the 'liquidation-losses-set-off-regime'.[876] The deductible liquidation loss is generally calculated as the difference between the participation's acquisition price and the sum of the liquidation proceeds.

Despite such a tax-deduction, this tax treatment triggers a liquidity disadvantage as a tax-deduction merely becomes available *ex post*, i.e., upon the winding up of the investment rather than at the time when the business losses have actually been suffered. Such a liquidity disadvantage distorts the choice of legal form as, in the case of business losses suffered, the tax treatment of a direct investment in a business activity, allowing for the set-off of losses when these actually occur, proves relatively more equitable. Real losses from equity investments should be deductible plainly when suffered.

Some states appreciated this in the past. An example is Spain, whose international tax regime used to allow for tax-deductible impairments of equity interests in (foreign) loss-making group companies; the deduction, however, was repealed from the system as of 1 January 2013.[877]

Distorting outbound investment under import neutrality promoting base exemption

[873] See Article 11(c) and (d) in conjunction with Article 14 (1)(g) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). Notably, European Commission, Common Consolidated Corporate Tax Base Working group (CCCTB WG) Working Paper No. 57, *CCCTB: possible elements of a technical outline,* Taxud E1, CCCTB/WP\057\doc\en, Brussels, 26 July 2007, at 9 (footnote 13) considers financing expenses not to qualify as *"costs incurred for the purpose of deriving income which is exempt pursuant to Article 11…"* See also Pasquale Pistone, 'Outbound Investments and Interest Deduction: an Era of Fat Cap in European International Tax Law?', in Michael Lang et al, *Common Consolidated Corporate Tax Base* (2008), at 860-862. Pistone recognizes the effect as well but does not seem to mind conceptually. Notably, the Presidency of the Council has suggested to introduce an earnings and stripping provision to counter CCCTB base erosion in this area; see the suggested Article 14a as found in the comments of the Presidency of the Council on the CCCTB proporsal (doc. 8387/12 FISC 49) published by the Council of the European Union, 16 April 2012, no. 2011/0058(CNS). This is not further discussed.

[874] See for a similar argument, Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55. See also Charles E. Mclure, Jr., 'State Taxation of Foreign-Source Dividends: Starting from First Principles', 30 *Tax Notes* 975 (10 March 1986), at 975-989, observing that expenses incurred to finance tax exempt income should not be tax deductible. At 975: *"Foreign-source dividends should not be subject to state corporate income taxes and (…) interest expense deemed to be incurred by the parent (or domestic subsidiaries) to finance investment in foreign subsidiaries should not be deductible in calculating the apportionable income of the water's edge group subject to state taxation."*

[875] This may be achieved by also crossing out the component '– α.r' from the taxable base. See the formula in footnote 869.

[876] Article 13d Dutch CITA.

[877] See Law 16/2013 of 29 October 2013, Establishing Certain Measures on Environmental Taxation and Taking other Tax and Financial Measures (Ley 16/2013, de 29 de octubre, por la que se establecen determinadas medidas en materia de fiscalidad medioambiental y se adoptan otras medidas tributarias y financieras).

In cross-border scenarios, i.e., in cases of equity investments in non-controlled participations operating business activities across the border, a participation exemption regime operates in a manner akin to the import neutrality promoting base exemption mechanism for juridical double tax relief purposes. That type of juridical double tax relief mechanism has been discussed in Chapter 3.

A base exemption mechanism for economic double tax relief purposes operates conceptually similar to a base exemption mechanism for juridical double tax relief purposes. It should be noted that juridical double taxation, economically, is also a form economic double taxation. In consequence, the conceptual problems relating to an import neutrality promoting juridical double tax relief mechanism necessarily equivalently occur under an import neutrality promoting economic double tax relief mechanism, such as the participation exemption.

As demonstrated in Chapter 3, under a territorial taxing system based on import neutrality – where income realized within the source state is taxed and foreign source income is not taken into consideration – the tax burden differs depending on whether the economic operator realizes its business income solely within the respective taxing state or across various states. For instance, losses suffered from economic operations indirectly carried on abroad are not tax-deductible under base exemption mechanisms, entailing an inequitable distorting increase in AETRs.

Hence, the conceptual basis for territorial tax systems is inequitable and inefficient as these systems – indeed neutral regarding the imports of production factors – unilaterally distort outbound movements of production factors from the source state to abroad (dislocations). This holds equally true in respect of both juridical and economical double tax relief mechanisms promoting the same underlying import neutrality concept. Viz., both deny a tax-deduction for foreign source losses that have actually been suffered. Import neutrality promoting double tax relief systems distort outward bound movements of production factors. And so does a participation exemption.

Ad B. The application of an indirect credit mechanism for economic double tax relief purposes at the level of the shareholder entails relief in two steps:

1. First, the pre-underlying-tax return on the shareholder's investment in the shareholders' interest – i.e., the proceeds from the respective participation without the underlying tax as imposed at the level of the participation being taken into consideration – is included in the shareholder's taxable base.[878] In practice, this amount typically is calculated by 'grossing-up' the post-underlying-tax return on the shareholder's equity investment, that is by multiplying the post-tax proceeds from the respective participation by a factor of '1/(1– t)'.[879] The tax impost is calculated accordingly;

2. Subsequently, second, the underlying tax that is levied at the level of the participation is credited against the tax levied at the shareholder's level, being the amount of tax calculated by making reference to the grossed-up proceeds from the respective participation.[880] Accordingly, the taxpayer receives a credit for underlying tax.

Also in respect of indirect credit mechanisms, two types of problems may be recognized, i.e., problems in their design as well as conceptual flaws.

Flaws in design

[878] $(\rho - \alpha.r) + (1 - d)$.
[879] $1/(1 - t).\{(\rho - \alpha.r) + (1 - d) + P.t_{sub}.[(\rho_{sub} - \alpha_{sub}.r_{sub}) + (1_{sub} - d_{sub})]\}$.
[880] $t.[(\rho - \alpha.r) + (1 - d)] - P.t_{sub}.[(\rho_{sub} - \alpha_{sub}.r_{sub}) + (1_{sub} - d_{sub})]$.

First, indirect credit regimes may not be designed consistently (for the 'second' see the header *Conceptual flaws* hereunder).[881] This is the case when the double tax relief mechanism provides relief in respect of the gross proceeds from a participation, such as dividends and capital gains. In such a case, a mismatch occurs if economically related expenses like financing expenses are disregarded for double tax relief purposes and remain tax deductible.[882] That is a mismatch between a creditable 'plus' and a tax-deductible 'minus'.

This issue has already been touched upon and referred to as the 'Bosal Loophole'. This issue conceptually occurs under each gross-based double tax relief mechanism. It can be resolved with relative ease by adopting a net-basis credit mechanism, which grants a credit for underlying tax economically attributable to the net proceeds from a participation.[883] Such responses may be found in states' international tax systems under tax credit limitations. An example is the indirect credit mechanism employed in the Netherlands regarding so-called 'non-qualifying portfolio participations' under the 'participation credit regime'. Under the so-called 'second limitation', the indirect credit granted is limited to the domestic corporate income tax as levied on the grossed-up proceeds from 'non-qualifying-portfolio-participations' after the deduction of attributable expenses.[884] Also the CCCTB proposal makes use of a switch-over to credit mechanism.[885] Economically related expenses are identified subsequent to a functional and factual analysis.

Another problematic element in the design of an indirect credit mechanism is that an indirect credit mechanism requires the taxpayer to have some knowledge on the tax position of the corporation in which it holds its minority shareholders' interest. Namely, the basic assumption of the indirect credit mechanism is that the underlying tax imposed at the level of the participation is credited against the tax levied at the shareholders' level.

This triggers problems with regards to non-controlling interests, which will consistently be the case as, in my view, controlling interests should be tax consolidated. The shareholder needs to obtain information on another person's tax affairs, which is not readily available to him. In addition, as the shareholder does not have a controlling interest in the respective corporate body, the shareholder *a priori* lacks the power to force that body to make the necessary information available.

> The awkward approach of the Court of Justice in *Haribo*: 'resort to market forces to resolve tax-induced distortion'

Nevertheless, states typically grant the double tax relief subject to the meeting of documentation requirements, such as the requirement to supply a precise indication of the underlying tax levied.[886] In cases where the Treaty on Functioning of the European Union applies, in the *Haribo* case for example, the Court of Justice gracelessly held that such an administrative burden imposed in respect of minority interests in foreign corporations does not infringe upon the EU's fundamental freedoms.[887]

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[881] (Dividend) imputation credit regimes can, e.g., be found in New Zealand and the United States. For some reading and analysis of indirect credit mechanisms, see International Fiscal Association, *Cahiers de droit fiscal international* (2011).

[882] The flaw emerges when the component ρ is crossed out, while the component – α.r is kept in. Merely the component ρ is taken into consideration for double tax relief purposes. Again, the consequence would be an imbalance arising between proceeds 'ρ' eligible for relief and tax-deductible expenses '– α.r', i.e., the 'Bosal Loophole'.

[883] This may be achieved by taking into account the component '– α.r' in determining the amount of double tax relief granted.

[884] See Article 13aa Dutch CITA in conjunction with Article 23c Dutch CITA. For a brief discussion on the operation of this mechanism in the Dutch international tax system reference see Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international (*2011), at 447-470.

[885] Article 73 Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).

[886] An example may be found in the current economic double tax relief measures found in the Austrian international tax system. For an overview of legislation concerning documentation requirements in this respect see Court of Justice, joined cases C-437/08 and C-436/08 (*Haribo & Salinen*).

[887] See Court of Justice, joined cases C-437/08 C-436/08 (*Haribo & Salinen*) and the Opinion of Advocate General Kokott delivered on 11 November 2010.

The case at hand concerned the application of the Austrian indirect tax credit mechanism. Amongst others, its application was subject to the requirement that the respective taxpayer submits relevant information to the tax authorities regarding the underlying corporation's tax affairs. In the *Haribo* case, the respective taxpayer, a minority shareholder, was unable to meet this requirement as he did not dispose of a controlling shareholding interest. Consequently, the relief mechanism did not apply, subjecting the taxpayer to tax cascading.

Following A-G Kokott's arguments, the Court of Justice observed that the capital markets would recover such an issue as it is in the interest of both parties to make minority shareholder investments as attractive as possible. This would include the provision of relevant information by corporations on their tax positions to minority shareholders, which, notably, in the real world does not occur. Information on companies' actual tax positions typically is not publicly available. According to both A-G Kokott and the Court of Justice, an inadequate flow of information to the investor is not a problem for which a Member State should have to answer. Hence, according to the Court of Justice, Member States are justified in imposing such an administrative burden.

To be honest, I have some difficulties in appreciating this approach of the Court of Justice. Oddly, Kokott and the Court of Justice justify the tax distortion by arguing that its distortive effects will be resolved by the market. In my view, they turn the world upside down by doing that. The internal market is built to attain collective well-being. With regards to direct taxation, this calls for equal and neutral tax treatment within the internal market. The mentioned 'lack-of-information-problem' has been caused by the state that designed the double tax relief mechanism at hand. The problem has not been caused by the taxpayer necessarily coping with the impossible to meet administrative requirements. Nevertheless, the taxpayer has been made the party that is subject to administrative requirements, which it is unable to meet. This has the consequence of it being subject to a distortive double taxation upon the failure of meeting these requirements.

The taxpayer pays the price for a flawed double tax relief mechanism. And the A-G's and court's response is: 'Deal with it, the capital market will recover this'. The inadequacy, however, in my opinion is just the symptom of the problem. That is, the distortive tax treatment that has been created by the Member State concerned. The A-G and the Court of Justice nevertheless resort to the market flexibilities to justify a flaw in the design of a Member State's tax system; despite that, the notion of the internal market calls for states to impose non-distortive tax systems.[888] I respectfully disagree. Tax distortions cannot be considered just in my view by simply referring to the possibility of them being recovered by the market.

Conceptual flaws

Distorting inbound investment under export neutrality promoting credit mechanism

Second, the adoption of an indirect tax credit mechanism for economic double tax relief purposes triggers conceptual issues when it concerns cases of foreign source equity investments in non-controlled participations. In such cross-border scenarios, an indirect tax credit mechanism operates in a manner akin to the export neutrality promoting a direct credit mechanism for juridical double tax relief purposes. That juridical double tax relief mechanism has been discussed in Chapter 3.

An indirect credit mechanism for economic double tax relief purposes operates conceptually similar to a direct credit mechanism for juridical double tax relief purposes. It should be noted that, as said, juridical double taxation is also economic double taxation. In consequence, the conceptual problems relating to an export neutrality promoting juridical double tax relief mechanism necessarily also occur under an export neutrality promoting economic double tax relief mechanism, such as the indirect credit.

[888] See for a comparison Daniel S. Smit, 'The Haribo and Österreichische Salinen Cases: To What Extent Is the ECJ Willing To Remove International Double Taxation Caused by Member States', 51 *European Taxation* 275 (2011), at 275-284.

As demonstrated in Chapter 3, international tax systems based on export neutrality – where worldwide income is taxed and a credit for foreign tax is granted – distort the competitive position of foreign economic operators in the source state. It, for instance, 'tops-up' the tax burden to residence state levels putting the non-resident taxpayer in a disadvantageous position in comparison with its local competitors, who are subject to diverging source state tax burdens. This was precisely the reason why the Subpart F rules in the US, at the time of their design in the 1960s, were not extended to apply to actively held controlled foreign companies; it would have put US business at a less advantageous competitive position relative to its local competitors.

Therefore, the analytical basis for these systems is inequitable and inefficient as these systems – which are indeed neutral regarding the exports of production factors – unilaterally distort inbound capital movements in the source state. This holds equally true in respect of both juridical and economical double tax relief mechanisms promoting the same underlying export neutrality concept. All export neutrality promoting double tax relief mechanisms distort inbound movements of production factors. An indirect tax credit mechanism also does this.

5.4.4.3 An equitable alternative to mitigate tax cascading: the 'indirect tax exemption'

Juridical double tax relief: the 'credit of domestic tax attributable to foreign income'

As both double tax relief mechanisms reveal their flaws, it may be worth exploring an alternative. In Chapter 3, the import neutrality promoting base exemption mechanism and the export neutrality promoting credit mechanism have been integrated into each other, thereby producing a juridical tax relief mechanism in respect of proceeds from cross-border direct investments. I referred to this as the '*credit for the domestic tax that is attributable to the foreign income items*', using a double tax relief methodology extracted from current Dutch international tax law as an analogy. As demonstrated this mechanism simultaneously promotes both the import and export of production factors.

As the 'credit for the domestic tax that is attributable to the foreign income items' discussed in Chapter 3 enhances fairness by promoting both inbound and outbound movements of production factors, perhaps an economic double tax relief mechanism operating in a similar manner may enhance fairness as well.

Economic double tax relief: something similar – the 'indirect tax exemption'

The question arises as to what such an economic double tax relief mechanism would look like. For this purpose, the required economic double tax relief method may be achieved by again combining the export neutrality promoting indirect credit mechanism and import neutrality promoting participation (i.e., base) exemption mechanism methods.

This would thereby produce an economic double tax relief mechanism that could be referred to as the 'indirect tax exemption'. The application of the 'indirect tax exemption' for economic double tax relief purposes at the level of the shareholder in respect of proceeds from minority shareholders' interests would provide relief in two consecutive steps:

1. First, the pre-underlying-tax return on the shareholder's investment in the shareholder's interest – i.e., the proceeds from the respective participation without the underlying tax as imposed at the level of the participation being taken into consideration – is included in the shareholder's taxable base.[889] In practice, this amount typically could be calculated by 'grossing-up' the post-underlying-tax return on the shareholder's equity investment, that is by multiplying the post-tax proceeds from the respective participation by a factor of '1/(1– t)'.[890] The tax impost is

[889] $(\rho - \alpha.r) + (1 - d)$.
[890] $1/(1 - t).\{(\rho - \alpha.r) + (1 - d) + P.t_{sub}.[(\rho_{sub} - \alpha_{sub}.r_{sub}) + (1_{sub} - d_{sub})]\}$.

calculated accordingly. Basically, the first step would be identical to the first step as applied under the indirect tax credit mechanism;

2. Subsequently, second, a credit becomes available. The credit equals the tax imposed at the level of the shareholder that is economically attributable to the net proceeds from the participation.[891] Accordingly, contrary to the indirect tax credit mechanism, the amount of credit available does not correspond to the tax actually imposed at the level at which the respective underlying corporation is disregarded. Instead, the credit granted is calculated autonomously. More specifically, the credit equals the amount of tax economically attributable to the proceeds of the respective entity in which the equity investment is held. Economically related expenses are identified subsequent to a functional and factual analysis. Hence, the creditable amount is calculated in a manner akin to the calculation of the indirect tax credit under the application of the tax credit limitation I referred to in the above as the 'second limitation'.

The relief would be calculated in a manner akin to the fraction as forwarded in Chapter 3 for juridical double tax relief purposes. It would apply according to the following fraction:

*(Grossed-up net proceeds from a participation / Worldwide Income) * Domestic Tax on Worldwide Income*

The grossed-up net proceeds from the participation are included in the taxable base with respect to which the tax impost is calculated accordingly (Step 1: 'In'). Subsequently, the tax that is economically attributable to these proceeds becomes available to be credited against the tax as calculated under the first step (Step 2: 'Out').

One may ask what the use of such an approach would be. Why consider it? It may be worth exploring though, as this economic double tax relief mechanism would provide an equitable and tax neutral solution for the tax cascading issues as caused under the application of the separate entity approach in the international tax regime. Moreover, it would promote neutrality regarding both inward bound and outward bound movements of production factors.

Illustrating the effects: back to Johnson

Let us illustrate things by returning to our running example of taxpayer Johnson and its indirect investment in the equity capital of a third party, i.e., the investment in a non-controlled participation. In addition, let us refer to that third party as 'Johnson's Participation in Distribution Co.'

Under a conventional corporate income tax, the corporate income tax calculations at the level of 'Johnson's Participation in Distribution Co.' are identical to those at the level of 'Johnson's Dinghy Sales Subsidiary Co.' as set forth in section 5.4.3 (which notably is a repetition of the calculations set forth in section 5.4.2). Under the assumption that the post-tax returns as derived by 'Johnson's Participation in Distribution Co.' immediately are repatriated to Johnson and the effects recognized at the level of Johnson are as follows (fig. 38):[892]

Fig. 38. Johnson's CIT Calculation

	Period 1	***Period 2***
Johnson's CIT Calculation		
Earnings		
Gross Earnings ('EBITDA')	0	+ 10,435[893]
Gross-up***)**	0	– 65[894]
Aggregate	0	+ 10,500[895]
Costs		

[891] $t.[(\rho - \alpha.r) + (1 - d)] - t.[(\rho - \alpha.r) + (1 - d)]$.
[892] Notably, dividend taxation again is assumed to be non-existent, a dividend tax exemption is considered to apply, or it is assumed that the dividend tax is fully creditable against corporate income tax.
[893] 10,500 – 65 = 10,435. Accordingly: $1 + \rho + P.t_{part}.[(\rho_{part} - \alpha_{part}.r_{part}) + (1_{part} - d_{part})]$.
[894] 0.25 * [(500 – 240) + (10,000 – 10,000)] = 65. Accordingly: $- P.t_{part}.[(\rho_{part} - \alpha_{part}.r_{part}) + (1_{part} - d_{part})]$.
[895] $1 + \rho$. Alternatively, $1/(1 - t).\{(\rho - \alpha.r) + (1 - d) + P.t_{part}.[(\rho_{part} - \alpha_{part}.r_{part}) + (1_{part} - d_{part})]\}$.

Financing Expenses (interest)	0	– 240[896]
Depreciation	0	– 10,000[897]
Aggregate	0	– 10,240[898]
Tax Levy		
Aggregate (Taxable Amount)	0	+ 260[899]
Tax*[*)] (25%)	0	+ 65[900]
'Indirect Tax Exemption'[*)]	0	– 65[901]
Aggregate / Tax Payable	0	0

*[*)] A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax creditable.

Alternatively, the corporate income tax payable can be calculated in the following steps:

1. The tax calculated on the grossed-up net proceeds from the participation, which equals €260 (i.e., €195[902] + €65[903]), amounts to €65;[904]
2. The double tax relief available amounts to €65;[905]
3. The tax payable, due to the absence of other sources of income, amounts to €0.

As a table (from left to right – fig. 39):

Fig. 39 Tax Positions of Johnson and 'Johnson's Participation in Distribution Co' (pro rata parte)

	Gross Earnings	***Gross-up***	***Tax base***	***Tax**[*)]***	***Relief**[*)]***	***Tax payable***
Johnson	+ 195	+ 65	+ 260	+ 65	– 65	0
Johnson's Participation (pro rata parte)	+ 260	n/a	+ 260	+ 65	n/a	+ 65

*[*)] A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax creditable.

Accordingly, Johnson's business activities produce the following business cash flows (fig. 40):

Fig. 40. Johnson's Cash Flow Statement

	Period 1	***Period 2***
Johnson's Cash Flow Statement		
Real Transactions ('R')		
Investment	– 10,000[906]	
Gross Return on Investment		+ 10,435[907]
Aggregate	– 10,000	+ 10,435
Financial Transactions ('F')		
Debt Issuance	+ 6,000[908]	
Repayment Principal Amount		– 6,000[909]
Interest Paid		– 240[910]
Aggregate	+ 6,000	– 6,240[911]
Tax Levy		
Tax*[*)] Johnson (25%)	0	0[912]

[896] – α.r.
[897] – d. For simplicity reasons, it is assumed that d = d_{part}.
[898] – α.r – d.
[899] (500 – 240) + (10,000 – 10,000) – (65 + 65) = 260. Accordingly: (ρ – α.r) + (1 – d) + P.t_{part}.[(ρ_{part} – α_{part}.r_{part}) + (1_{part} – d_{part})] – P.t_{part}.[(ρ_{part} – α_{part}.r_{part}) + (1_{part} – d_{part})] = (ρ – α.r) + (1 – d). For technical reasons, alternatively, one may decide on adopting: 1/(1 – t).{(ρ – α.r) + (1 – d) + P.t_{part}.[(ρ_{part} – α_{part}.r_{part}) + (1_{part} – d_{part})]}.
[900] 0.25 * [(500 – 240) + (10,000 – 10,000) – (65 + 65)] = 65. Accordingly: t.[(ρ – α.r) + (1 – d)].
[901] – 0.25 * [(500 – 240) + (10,000 – 10,000) – 65 + 65] = –65. Accordingly: –t.[(ρ – α.r) + (1 – d)].
[902] 435 – 240 = 195.
[903] 0.25/0.75 * 195 = 65.
[904] 0.25 * 260 = 65.
[905] 260 / 260 * 65 = 65.
[906] – 1.
[907] 10,500 – 65 = 10,435. Accordingly: 1 + ρ + P.t_{part}.[(ρ_{part} – α_{part}.r_{part}) + (1_{part} – d_{part})].
[908] α.
[909] – α.
[910] – α.r.
[911] – α.(1 + r).
[912] t.[(ρ – α.r) + (1 – d)] – t.[(ρ – α.r) + (1 – d)].

Aggregate	– 4,000[913]	+ 4,195[914]

***)** A tax preceded by a '+' sign represents an amount of tax payable

The net outbound cash flow in period 1 equals €4,000, an amount equal to the invested equity capital. The transactions in period 1 do not constitute a taxable event under a conventional corporate income tax. The net inbound cash flow in period 2 nevertheless alters in comparison to a no tax environment. Now, the inflow in period 2 equals €4,195. The net return to the invested equity capital ('v_C^{DTR}') equals €195, a percentage of 4.875.[915] What does this number tell us?

Back to where we left off…

It seems that we are back to where we started in section 5.4.2, i.e., the section forwarding the effects under a typical corporate income tax in the case of a direct investment.

- The additional issues created under the recognition for tax purposes of the separate entity approach in conventional corporate income taxation in respect of indirect investments in non-controlled participations, i.e., the economic multiple taxation issue, has been resolved conceptually in an equitable and tax neutral manner.

- Furthermore, the problematic elements in the typical economic double tax relief mechanisms, the participation (base) exemption and indirect credit mechanism, do not occur under the 'indirect tax exemption mechanism'. It provides for a net double tax relief mechanism and it promotes neutrality regarding both inbound and outbound movements of production factors.

- Moreover, the 'impossible-to-meet-administrative-requirements' under the indirect tax credit are absent as the relief is calculated autonomously, i.e., regardless of the underlying tax payable. In addition, the indirect tax exemption would operate autonomously, and with that would be non-distortive, also in conjunction with the 'credit for the domestic tax that is attributable to the foreign income items', i.e., the juridical double tax relief mechanism that is extensively discussed in Chapter 3.

Please let me elaborate on this.

No 'Bosal Loophole'

First, the issue referred to in the above as the 'Bosal Loophole' does not arise. The indirect tax exemption mechanism provides for relief on a net-basis. Accordingly, no mismatch occurs between exempted profits and tax-deductible expenses. The design flaws recognized under some of the participation (base) exemption and indirect credit mechanisms in place in the international tax regime remain absent.

Neutrality towards inbound and outbound investment

Second, the indirect tax exemption mechanism resolves the conceptual problems – the 'topping-up-effect' – that appear under the export neutrality promoting indirect credit mechanisms as currently are in place worldwide. As relief is granted autonomously, while disregarding the underlying (foreign) taxes levied, the 'indirect tax exemption mechanism' operates in a unilaterally tax neutral fashion.

As it operates in a manner akin to the 'credit for the domestic tax that is attributable to the foreign income items', the indirect tax exemption mechanism enhances import neutrality in cross-border scenarios. Tax burdens imposed are identical irrespective of the taxpayer's

[913] $-(1-\alpha)$.
[914] $(1-\alpha) + (\rho - \alpha.r + P.t_{part}.[(\rho_{part} - \alpha_{part}.r_{part}) + (1_{part} - d_{part})])$.
[915] $(4{,}195 / 4{,}000) - 1 = 0.04875$. Accordingly: $v_{CIT}^{DTR} = (1-\alpha) + (\rho - \alpha.r + P.t_{part}.[(\rho_{part} - \alpha_{part}.r_{part}) + (1_{part} - d_{part})]) / (1-\alpha) - 1 = (\rho - r + P.t_{part}.[(\rho_{part} - \alpha_{part}.r_{part}) + (1_{part} - d_{part})]) / (1-\alpha) + r$.

place of residence. Accordingly, it refrains from distorting inbound investments as is the case under export neutrality promoting credit mechanisms.

Moreover, contrary to the existing indirect credit mechanism, the indirect tax exemption mechanism does not require taxpayers claiming relief to have knowledge on the tax position of the corporation if the minority interest is held. Relief is granted on an autonomous basis, plainly by referring to the tax attributable to the net income derived from the taxpayer's investment.

Allowing for cross-border loss offset

Third and finally, the indirect tax exemption mechanism resolves the conceptual problems triggered by the import neutrality promoting base exemption mechanism, as it, contrary to a base exemption, allows for a deduction or set-off of losses when suffered. As the mechanism enables cross-border loss set-off as well, it enhances export neutrality in cross-border scenarios. Tax burdens imposed are identical irrespective of the question of whether taxpayer's operate their economic activities in a domestic or cross-border context. Accordingly, it refrains from distorting outbound investments as is the case under import neutrality promoting base exemption mechanisms.

5.4.4.4 Loss recapture and profit carry-forward mechanisms required

Adding two features two the system: a 'recapture of losses feature' and a 'carry-forward of profits feature'

To ascertain single taxation under a conventional corporate income tax, two features should be added. Analogue or equivalent to the 'credit for the domestic tax that is attributable to the foreign income items mechanism', the indirect tax exemption calls for a 'recapture of losses feature' and a 'carry-forward of profits feature'.

This requires some further elaboration. Up until this point, the numerical examples forwarded in this study consider scenarios where the investment return is derived in a single taxable period, i.e., period 2. Under a conventional corporate income tax, this does not necessarily need to be the case. Where the return has been derived across multiple taxable periods, taxable profits are attributed to these taxable periods under (tax) accounting principles that, as said, typically align with common business economics and commercial accounting principles (e.g. the reality, matching, realization and prudence principles). This triggers the question as to how to deal with this under the application of the advocated indirect tax exemption mechanism. For instance, in the event that a taxable proceed in the negative (a tax loss to be vertically compensated) has been derived in one taxable period, while a taxable proceed in the positive has been derived in the other.

Illustrating the effects: back to Johnson

A 'recapture of losses feature' and a 'carry-forward of profits feature' would support the attribution process equitably and neutrally. The effects, as always, can be illustrated best by means of numerical examples.

Let us assume that the imposition of corporate income tax now occurs in two taxable periods, 'Taxable Period 1' and 'Taxable Period 2'. Accordingly, 'Period 2' referred to in the above tables is divided into two distinctive taxable periods. Moreover, let us assume that Johnson, in addition to the proceeds derived from its investment in 'Johnson's Participation in Distribution Co.', which for the sake of convenience is now relabeled as 'source a)', derives income from a direct investment, for convenience labeled as 'source b)'. In addition let us consider the following three alternative scenarios:

1. The yields derived from both sources, i.e., 'Johnson's Participation in Distribution Co.', 'source a)' and the additional direct investment, 'source b)', account for a positive amount in both taxable periods;

2. The yield from 'source a)', accounts for a negative amount in 'Taxable Period 1' and for a positive amount in 'Taxable Period 2'; the yield from the additional 'source b)', account for a positive amount in both taxable periods; to ensure single taxation, a recapture mechanism is required.
3. The yield from 'source a)' accounts for a positive amount in both taxable periods; the yields from the additional 'source b)' account for a negative amount in 'Taxable Period 1' and for a positive amount in 'Taxable Period 2'; to ensure single taxation, a carry-forward mechanism is required.

Ad 1. The yields derived from both sources account for positive amounts in both taxable periods. Assume that the net return on the investment in source a), 'Johnson's Participation in Distribution Co.', remains unchanged and equals €195. And assume that the net return on the investment in the additional direct investment, source b), equals €500. The returns are attributed to the taxable periods in the following manner. The taxable proceeds in respect of source a) tax account for €75 in 'Taxable Period 1' and €120 in 'Taxable Period 2'. The underlying taxable profits of 'Johnson's Participation in Distribution Co.', i.e., to the extent that they are *pro rata parte* attributed to Johnson equity investment respectively, hereinafter labeled as 'source a)*', respectively equal €100 and €160. The taxable proceeds in respect of source b) equally account for €250 in both taxable periods. The tax rate remains equal to a linear 25%. Forwarded as a schedule (fig. 41):

Fig. 41. Given attribution taxable proceeds to taxable periods 1 and 2

	Sources of income	***Yields Taxable Period 1***	***Yields Taxable Period 2***	***∑***
Johnson	source a)	75	120	195 (double tax relief)
	source b)	250	250	500
Johnson's Participation (pro rata parte)	source a)*	100	160	260

Under these circumstances, the tax effects under the application of the indirect tax exemption would operate accordingly (figs. 42, 43 and 44):

Fig. 42. Taxable Period 1; tax positions Johnson & Johnson's Participation

	a)	***a)****	***b)***	***Gross-up /1***	***∑ Tax base***	***Tax levy***	***Econ. double tax relief /2***	***Tax Payable /3***
Johnson	75	-	250	25	350	87.50	25	62.50
Johnson's Participation	-	100	-	-	100	25	-	25

/1: 0.25 / 0.75 * 75 = 25;
/2: (75 + 25) / 350 * 87.50 = 25;
/3: 87.50 – 25 = 62.50.

Fig. 43. Taxable Period 2; tax positions Johnson & Johnson's Participation

	a)	***a)****	***b)***	***Gross-up /1***	***∑ Tax base***	***Tax levy***	***Econ. double tax relief /2***	***Tax Payable /3***
Johnson	120	-	250	40	410	102.50	40	62.50
Johnson's Participation	-	160	-	-	160	40	-	40

/1: 0.25 / 0.75 * 120 = 40;
/2: (120 + 40) / 410 * 102.50 = 40;
/3: 102.50 – 40 = 62.50.

Fig. 44. Taxable Periods 1 & 2; Overall Tax Positions Johnson & Johnson's Participation

	Tax Payable Taxable Period 1	***Tax Payable Taxable Period 2***	***∑ Tax Payable***
Johnson source a), post-double tax relief	0	0	0

Johnson source b)	62.50	62.50	125
*Johnson's Participation source a)**	25	40	65

The tables illustrate that Johnson, in effect, would only be liable to pay tax on the €500 return on its direct investment, source b). Johnson would be liable to pay an amount of tax equal to €62.50 in Taxable Period 1 and €62.50 in Taxable Period 2. That is an aggregate tax payable of €125. That amount equals an overall nominal tax payable imposed at a 25% rate. The (grossed-up) return on Johnson's investment in 'Johnson's Participation in Distribution Co.', 'source a)', of €260 does not trigger a tax liability at the level of Johnson. This would be fair as Johnson's Participation in Distribution Co.' already would be liable to pay tax on the underlying proceeds, i.e., source a)*. These equal €260, leaving a tax payable at the level of the participation of €65, specifically €25 in Taxable Period 1 and €40 in Taxable Period 2.

Economic single taxation efficiently achieved

Accordingly, economic single taxation on the underlying proceeds of €260, source a)*, would be achieved. In terms of nominal amounts of tax payable, the attribution of the proceeds to taxable periods does not entail any differences in tax treatment under the application of the indirect tax exemption mechanism (leaving the time value of money out of consideration – the operation of the system is assessed under a conventional corporate tax). That is, in comparison with the scenario set forth in section 5.4.2 (The effects involving a direct investment). Accordingly, the distortions recognized under a conventional corporate income tax are not exacerbated any more. The nominal amount of corporate income tax payable remains unchanged. The preliminary conclusion that we are back to where we left off in section 5.4.2 remains unchanged as well. Accordingly, the indirect tax exemption mechanism, to this extent, operates equitably.

Ad 2. The yields from 'source a)', account for a negative amount in 'Taxable Period 1' and for a positive amount in 'Taxable Period 2', while the yields from 'source b)' account for positive amounts in both taxable periods. Assume that the net return to the investment in source a), 'Johnson's Participation in Distribution Co.', remains unchanged and equals €195. And assume that the net return on the investment in the additional direct investment, source b), equals €500. However, the returns are attributed to the taxable periods differently compared to the scenario *Ad 1*. The taxable proceeds in respect of source a) account for €75 in the negative in 'Taxable Period 1' and €270 in the positive in 'Taxable Period 2'. The underlying taxable profits of 'Johnson's Participation in Distribution Co.', i.e., to the extent that they are *pro rata parte* attributed to Johnson equity investment respectively, 'source a)*', respectively equals €100 in the negative (loss to be compensated vertically) and €360. The taxable yields in respect of source b) remain unchanged and account equally for €250 in both taxable periods. Forwarded as a schedule (fig. 45):

Fig. 45. Given attribution taxable proceeds to taxable periods 1 and 2

	Sources of income	***Yields Taxable Period 1***	***Yields Taxable Period 2***	∑
Johnson	source a)	<75>	270	195 (double tax relief)
	source b)	250	250	500
Johnson's Participation (pro rata parte)	source a)*	<100>	360	260

To secure single taxation, now a loss-recapture mechanism, equivalent to the recapture mechanism for juridical double tax relief purposes as set forth in Chapter 3, is required. Such a recapture would need to operate accordingly (figs. 46, 47 and 48):

Fig. 46. Taxable Period 1; tax positions Johnson & Johnson's Participation

a)	***a)****	***b)***	***Gross-up /1***	***Loss Carry forward***	***∑ Tax base***	***Tax levy***	***Double tax relief Recapture /****	***Econ. double tax relief***	***Tax Payable /3***	*Tax Payable /3*

									/2		
Johnson	<75>	-	250	<25>	-	150	37.50	<100>	0	37.50	62.50
Johnson's Participation	-	<100>	-	-	<100>	0	0	-	-	0	25

/1: 0.25 / 0.75 * <75> = <25>;
/2: n/a; 0
/3: 0,25 * 150 = 37.50.
/*: Administrative notice: double tax relief recapture next year

Fig. 47. Taxable Period 2; tax positions Johnson & Johnson's Participation

	a)	***a)****	***b)***	***Gross-up /1***	***Loss Carry forward***	***∑ Tax base***	***Tax levy***	***Double tax relief Recapture *)***	***Econ. double tax relief/2***	***Tax Payable /3***	*Tax Payable /3*
Johnson	270	-	250	90	-	610	152.50	100	65	87.50	62.50
Johnson's participation	-	360	-	-	100	260	65	-	-	65	25

/1: 0.25 / 0.75 * 270 = 90;
/2: (270 + 90 – 100/*) / 610 * 152.50 = 65;
/3: 152.50 – 65 = 87.50
/*: recapture reduces numerator double tax relief fraction

Fig. 48. Taxable periods 1 & 2; overall tax positions Johnson & Johnson's participation

	Tax Payable Taxable Period 1	***Tax Payable Taxable Period 2***	***∑ Tax Payable***
Johnson source a), post-double tax relief	0	0	0
Johnson source b)	37.50	87.50	125
Johnson's Participation source a)*	0	65	65

The tables illustrate that Johnson, in effect, would be liable to pay tax on the €500 return on its direct investment, source b). Johnson would be liable to pay an amount of tax equal to €37.50 in Taxable Period 1 and €87.50 in Taxable Period 2. That is an aggregate tax payable of €125. That amount equals an overall nominal tax payable imposed at a 25% rate. The (grossed-up) return on Johnson's investment in 'Johnson's Participation in Distribution Co.', 'source a)', of €260 does not trigger a tax liability at the level of Johnson. This is fair as Johnson's Participation in Distribution Co.', already would be liable to pay tax on the underlying proceeds, i.e., source a)*. These equal €260 triggering a tax payable at the level of the participation of €65, specifically €0 in Taxable Period 1 due to the tax loss suffered and €65 in Taxable Period 2.

Economic single taxation efficiently achieved

Accordingly, due to the recapture mechanism, economic single taxation of the underlying proceeds of €260, source a)*, would be achieved. The loss suffered is recognized for tax calculation purposes in Taxable Period 1.

This is fair. The loss has been suffered at that time. No liquidity disadvantage arises if put in comparison with a typical participation (base) exemption mechanism. The liquidity disadvantages, imposed under a conventional corporate income tax system which e.g. does not provide for a refund upon a loss suffered, are not exacerbated. The Taxable Period 1 loss is recaptured in Taxable Period 2 for economic double tax calculation purposes to ensure that the loss is not taken into account twice (which would entail economic non-taxation).

Technically, the recapture in Taxable Period 2 takes place by reducing the numerator in the double tax relief mechanism's fraction with an amount equal to the loss suffered in Taxable

Period 1. Conceptually, the recapture operates in a manner akin to the recapture in the juridical double tax relief mechanism advocated in Chapter 3, section 4.2.2. [916]

In summary, in terms of nominal amounts of tax payable, the attribution of the proceeds to taxable periods does not entail any differences in tax treatment (leaving the time value of money out of consideration) under the application of the indirect tax exemption mechanism. That is, in comparison with the scenario set forth in section 5.4.2 of the current chapter (The effects involving a direct investment). Accordingly, the distortions recognized under a conventional corporate income tax system are not exacerbated. The nominal amount of tax payable remains unchanged. The preliminary conclusion that we are back to where we left off in section 5.4.2 remains unchanged. Accordingly, the indirect tax exemption mechanism, also to this extent, operates equitably.

Ad 3. The yields from 'source a)' account for positive amounts in both taxable periods. The yields from the additional 'source b)' account for a negative amount in 'Taxable Period 1' and for a positive amount in 'Taxable Period 2'. Assume that the net return to the investment in source a), 'Johnson's Participation in Distribution Co.', remains unchanged and again equals €195. And assume that the net return to the investment in the additional direct investment, source b), equals €500. However, again the returns are attributed to the taxable periods differently. Assume that, like the scenario ad. 1, the taxable proceeds in respect of source a) remain unchanged and this time account for €75 in 'Taxable Period 1' and €120 in 'Taxable Period 2'. The underlying taxable profits of 'Johnson's Participation in Distribution Co.', i.e., to the extent that they are *pro rata parte* attributed to Johnson equity investment, 'source a)*', respectively equal €100 and €160. This time, the taxable proceeds in respect of source b) alter. The proceeds from source b) tax account for €150 in the negative in 'Taxable Period 1' (loss to be compensated vertically) and €650 in the positive in 'Taxable Period 2'. Forwarded as a schedule (fig. 49):

Fig. 49. Given attribution taxable proceeds to taxable periods 1 and 2

	Sources of income	***Yields Taxable Period 1***	***Yields Taxable Period 2***	∑
Johnson	source a)	75	120	195 (double tax relief)
	source b)	<150>	650	500
Johnson's Participation (pro rata parte)	source a)*	100	160	260

To secure single taxation, now a profit carry-forward mechanism, equivalent to the carry-forward mechanism for juridical double tax relief purposes as set forth in Chapter 3, is required. Such a carry-forward would need to operate accordingly (figs. 50, 51 and 52):

Fig. 50. Taxable Period 1; tax positions Johnson & Johnson's participation

	a)	***a)****	***b)***	***Gross-up /1***	***Loss Carry forward***	***∑ Tax base***	***Tax levy***	***Double tax relief carry forward /****	***Econ. double tax relief /2***	***Tax Payable /3***	Tax Payable /3
Johnson	75	-	<150>	25	<50>	0	0	100	0	0	62.50
Johnson's Participation	-	100	-	-	-	100	25	-	-	25	25

/1: 0.25 / 0.75 * 75 = 25;
/2: n/a; 0
/3: n/a; 0 / 0,25 * 100 = 25 (Johnson's participation);
/*: Administrative notice: double tax relief carry forward to next year

[916] A liquidation losses set-off regime allowing the corporate taxpayer involved to tax-deduct final losses realized upon the liquidation of a (foreign) corporate body in which the taxpayer holds a shareholding interest, such as the one adopted by the Netherlands (laid down in Article 13d Dutch CITA, would become redundant. The same holds true for a type of 'add-back-regulation', such as the one adopted by the Netherlands (laid down in Article 13aa-6 Dutch CITA. Such an amendment would enhance fairness relative to these measures as they entail liquidity disadvantages for merely enabling the setting-off of a tax loss at a moment later in time than actually suffered.

Fig. 51. Taxable Period 2; tax positions Johnson & Johnson's participation

	a)	***a)****	***b)***	***Gross-up /1***	***Loss Carry forward***	***∑ Tax base***	***Tax levy***	***Double tax relief Carry forward **)***	***Econ. double tax relief /2***	***Tax Payable /3***	Tax Payable /3
Johnson	120	-	650	40	<50>	760	190	<100>	65	125	62.50
Johnson's Participation	-	160	-	-	-	160	40	-	-	40	25

/1: 0.25 / 0.75 * 120 = 40;
/2: (120 + 40 + 100/*) / 760 * 190 = 65;
/3: 190 – 65 = 125
/*:carry forward increases numerator double tax relief fraction

Fig. 52 Taxable Periods 1 & 2; overall tax positions Johnson & Johnson's participation

	Tax Payable Taxable Period 1	***Tax Payable Taxable Period 2***	***∑ Tax Payable***
Johnson source a), post-double tax relief	0	0	0
Johnson source b)	0	125	125
*Johnson's Participation source a)**	25	40	65

The tables illustrate that Johnson, in effect, would be liable to pay tax on the €500 return on its direct investment, source b). Johnson would be liable to pay an amount of tax equal to €0 in Taxable Period 1 due to the taxable loss suffered and €125 in Taxable Period 2. That is an aggregate tax payable of €125. That amount equals an overall nominal tax payable imposed at a 25% rate. The (grossed-up) return on Johnson's investment in 'Johnson's Participation in Distribution Co.', 'source a)', of €260 does not trigger a tax liability at the level of Johnson. This is fair as Johnson's Participation in Distribution Co.', already would be liable to pay tax on the underlying proceeds, i.e., source a)*. These equal €260 triggering a tax payable at the level of the participation of €65, specifically €25 in Taxable Period 1 and €40 in Taxable Period 2.

Economic single taxation efficiently achieved

Accordingly, due to the profit carry-forward mechanism, economic single taxation of the underlying proceeds of €260, source a)*, would be achieved. The loss suffered from source b) is recognized for tax calculation purposes in Taxable Period 1 and set-off against the taxable income from source a), leaving a nil amount of tax payable. However, as a conventional corporate income tax does not provide for a tax refund, a latent double tax relief entitlement with respect to the proceeds from source a) in Taxable Period 1 arises. To ensure that this relief entitlement is appreciated, the application of the carry-forward mechanism entails that the source a) profit realized in Taxable Period 1 does not diminish for economic double tax relief purposes but, instead, is taken into account as a profit eligible for relief in Taxable Period 2. Consequently, relief becomes available in Taxable Period 2, guaranteeing economic single taxation.

Technically, the carry-forward in Taxable Period 2 takes place by increasing the numerator in the double tax relief mechanism's fraction with an amount equal to the carried forward proceeds from source a) to the extent that no relief is granted in Taxable Period 1. Conceptually, the carry-forward operates in a manner akin to the carry-forward feature in the juridical double tax relief mechanism advocated in Chapter 3, section 4.2.3.[917] Accordingly, no liquidity disadvantages arise in addition to any liquidity disadvantages already imposed under a conventional corporate income tax.

[917] A tax credit carry forward mechanism, such as the one adopted by the Netherlands (laid down in Article 23c-7 Dutch CITA), would become redundant.

In summary, in terms of nominal amounts of tax payable, the attribution of the proceeds to taxable periods does not entail any differences in tax treatment (leaving the time value of money out of consideration) under the application of the indirect tax exemption mechanism. That is, if it is in comparison with the scenario set forth in section 5.4.2 (The effects involving a direct investment). Accordingly, the distortions recognized under a conventional corporate income tax would not be exacerbated. The nominal amount of tax payable remains unchanged. The preliminary conclusion that we are back to where we left off in section 5.4.2 remains unchanged. Accordingly, the indirect tax exemption mechanism, also to this extent, operates equitably.

5.4.4.5 Yet, core issues remain in place, so we need something else…

However, regardless of the fairness enhancing properties of the advocated double tax relief mechanisms for both juridical and economic double tax elimination purposes, the underlying problematic features of the conventional corporate income tax system as identified in sections 5.4.1 and 5.4.2 remain in place. As said, it particularly concerns:

1. The 'tax-wedge' between pre-tax and post-tax rate of returns;
2. The 'financing discrimination', and;
3. The distortions at the margin.

At the end of the day, we have merely resolved the problems recognized in section 5.4.3, which arise on top of the problems recognized already in section 5.4.2. Accordingly, we are still dealing with the derived nominal return to the invested equity capital as the foundation concept for taxable profit calculation purposes.

To resolve the distortive features of the conventional corporate income tax, rigorous alternatives need to be scrutinized. This simply holds true if one acknowledges that an issue cannot be resolved within a framework identical to the one that created it. We need another foundation concept for taxable profit calculation purposes. This requires one to set conventional 'tax-thinking' aside and commence exploring alternatives.

5.5 Problematic effects under Comprehensive Business Income Tax

5.5.1 General remarks

5.5.1.1 A CBIT taxes EBIT

Let us commence with the so-called 'Comprehensive Business Income Tax' ('CBIT').[918] The CBIT basically operates as a conventional corporate income tax with one vast difference: A CBIT excludes from the taxable base all proceeds from financing arrangements. Accordingly, outbound interest payments, for instance, are non-tax-deductible irrespective of whether debtor and creditor are affiliated. Interest receipts are exempt from tax (or eligible to be credited). Consequently, the tax base is basically calculated by making reference to an investor's operational income or so-called 'earnings before interest and tax' ('EBIT'). A CBIT taxes EBIT.

5.5.1.2 Creating tax-parity in financing by denying deduction for debt financing

Due to the non-provision of a tax deduction regarding interest payments, the financing discrimination issue, i.e., the difference in tax treatment between debt and equity financing, as

[918] The CBIT has been proposed in the early 1990s by the US Department of the Treasury. See U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, Washington, DC (1992). For an analysis of the CBIT, see Ruud A. de Mooij et al, 'An applied analysis of ACE and CBIT reforms in the EU', 18 *International Tax and Public Finance* 93 (2011), at 93-120, as well as Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264.

recognized under a conventional corporate income tax, is sought to be resolved by granting debt financing the exact same tax treatment as equity financing. Viz., both interest payments and dividend payments qualify as non-deductible items for tax calculation purposes. Both the remuneration for the provision of capital and enterprise are taken into consideration for tax calculation purposes. This typical feature accordingly renders the CBIT a significantly broader taxable base in comparison with a conventional corporate income tax (as the latter recognizes debt financing for tax calculation purposes).

To my knowledge, currently there is not a single state that has adopted a CBIT in its international direct tax system. That is, at least not to its full extent. Various states' international tax systems have features that, to some extent, embrace the CBIT's approach of not granting a deduction for interest payments. Typical examples are the various *ad hoc* interest deduction limitations that can be found in the international tax regime. Worth mentioning here is Hungary, which, at an earlier time, applied a 50% base exemption for intra-group interest payments (i.e., non-deduction of interest payment, non-taxation of interest receipt).[919] Another example is the Netherlands, which also at an earlier time had contemplated the introduction of a 'mandatory group interest box' *de facto* allowing for an 80% base exemption for proceeds from intra-group debt arrangements.[920] Interest deduction limitations, such as thin capitalization measures – i.e., a mechanism disabling the tax-deduction of interest payments to the extent of what is considered excessive debt financing under a statutory debt to equity ratio or arm's length standard – can for instance be found in Denmark, France, Spain, Australia, New Zealand, Japan and the UK.[921] Finally, earnings-stripping rules denying a deduction of interest payments exceeding a certain level relative to the respective taxpayer's EBIT and irrespective of the debtor's and creditor's affiliation may be mentioned in this respect as an example of a tax measure currently in place that conceptually comes nearest to a full-fledged CBIT.[922] Earnings and stripping regimes are for instance in place in Denmark, Germany, Italy and the United States.

5.5.2 The effects involving a direct investment

5.5.2.1 Assessing the investment returns of 'Ben Johnson Dinghy Selling Company'

The operation of a CBIT can be illustrated best by means of a numerical example. Let us return to our taxpayer Johnson and its dinghy business activities. As said, Johnson invests in a dinghy sales activity. The tax rate equals a linear 25% (again, progressivity is not considered for mere simplicity reasons). Under a CBIT, the effects are as follows (fig. 53):

Fig. 53. Johnson's CBIT calculation

	Period 1	***Period 2***
Johnson's CBIT calculation		
Earnings		
Gross Earnings ('EBITDA')	0	+ 10,500[923]
Aggregate	0	+ 10,500
Costs		
Depreciation	0	– 10,000[924]

[919] This regime has been repealed as of January 1, 2010. For some details see Roland Felkai, 'Hungary, 2010 Tax Changes', 49 *European Taxation* 611 (2009), at 611-613.
[920] The mandatory Dutch group interest box regime was proposed in the letter of the Dutch State Secretary for Finance to Parliament of 15 June 2009, DB/2009/227U and subsequently withdrawn in the Letter of the Dutch State Secretary for Finance to Parliament of 5 December 2009, DB2009/674M. The regime would have been laid down in Article 12c Dutch CITA.
[921] The regimes can be found respectively in §11 Danish CTA, Article 212 French CGI, Article 20 Spanish CITA'), Division 820 (Thin capitalization rules) Australian IITA 1997, subpart FE (Interest apportionment on thin capitalisation) New Zealand ITA, Article 66-5 Japanese Special Taxation Measures Law ('Japanese SMTL') and Schedule 28AA UK Income and Corporation Taxes Act 1988 (as added to ICTA by the Finance Act 1998). In addition, UK legislation governing the arm's length provision of cross border finance between affiliates is at Section 209(2)(da) ICTA 1988 and Schedule 28AA ICTA 1988.
[922] Respectively to be found in §11C Danish CTA, §4h of the German Einkommensteuergesetz ('German Income Tax Code' or 'EStG'), articles 167 and 168 of the Italian Tax Code and §163(j) (Limitation on deduction for interest on certain indebtedness) US IRC.
[923] $1 + \rho$.
[924] $- d$.

Aggregate	0	– 10,000
Tax Levy		
Aggregate (Taxable Amount)	0	+ 500[925]
Tax[*)] (25%)	0	+ 125[926]

[*)] A tax preceded by a '+' sign represents an amount of tax payable.

Johnson's business activities produce the following business cash flows (fig. 54):

Fig. 54. Johnson's Cash Flow Statement

	Period 1	***Period 2***
Johnson's Cash Flow Statement		
Real Transactions ('R')		
Investment	– 10,000[927]	
Gross Return on Investment		+ 10,500[928]
Aggregate	– 10,000[929]	+ 10,500[930]
Financial Transactions ('F')		
Debt Issuance	+ 6,000[931]	
Repayment Principal Amount		– 6,000[932]
Interest Paid		– 240[933]
Aggregate	+ 6,000	– 6,240[934]
Tax Levy		
Tax[*)] (25%)	0	+ 125[935]
Aggregate	– 4,000[936]	+ 4,135[937]

[*)] A tax preceded by a '+' sign represents an amount of tax payable.

The net outbound cash flow in period 1 again equals €4,000, an amount equal to the invested equity capital. The transactions in period 1 are not considered to constitute a taxable event under a CBIT. The CBIT shares this feature with the conventional corporate income tax. The net inbound cash flow in period 2 nevertheless alters. This holds true both in comparison with a no tax environment and the scenario under a conventional corporate income tax. This time, the inflow in period 2 equals €4,135. The net post-tax return to the invested equity capital ('v_{CBIT}') equals €135, a percentage of 3.375.[938] What does this tell us? The numbers tell us three things (see sections 5.5.2.2, 5.5.2.3, and 5.5.2.4).

5.5.2.2 Average Effective Tax Rates; the 'tax-wedge'

First, it tells us something about the average effective tax rate ('AETR') under a CBIT. A CBIT taxes operational profit, EBIT. It not only taxes the nominal return to equity, i.e., the excess earnings (€100) and the opportunity costs of equity capital (€160), it also taxes the costs of debt capital (€240). These three components taken together respectively produce the €25, €40 and €60, i.e., an aggregate of €125 tax payable. Inflation is disregarded for CBIT calculation purposes. CBIT taxes nominal returns.

Let us calculate AETRs. As mentioned, AETRs are calculated by dividing the tax payable (numerator) by the pre-tax income (denominator).[939] The tax payable to be adopted in the

[925] 500 + (10,000 – 10,000) = 500. Accordingly: ρ + (1-d).
[926] 0.25 * 500 + (10,000 – 10,000) = 125. Accordingly: t.[ρ + (1 – d)].
[927] – 1.
[928] 1 + ρ.
[929] – 1.
[930] 1 + ρ.
[931] α.
[932] – α.
[933] – α.r.
[934] – α.(1 + r).
[935] t.[ρ + (1 – d)].
[936] – (1 – α).
[937] (1 – α) – (α.r) + (1 – t).ρ – t.(1 – d).
[938] (4,135 / 4,000) – 1 = 0.03375. Accordingly: $v_{CBIT} = (1 – α) – (α.r) + (1 – t).ρ – t. (1 – d) / (1 – α) – 1 = [(ρ – r) – t.ρ] / (1 – α) – t. (1 – d) / (1 – α) + r.$
[939] See for a comparison Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 73.

numerator equals €125. With respect to the amount to be adopted in the denominator, the remarks referred to in the above should be repeated. Johnson's pre-tax return of €260, as said, comprises of two components. The first component amounting to €100 refers to the excess earnings, the remuneration for the production factor of enterprise. The second component amounting to €160 refers to the normal market return rate (opportunity costs of capital), or the remuneration for the equity capital provided. Again, the question arises as to which of these amounts should be taken into consideration?[940]

If the pre-tax nominal return to equity, €260, is adopted as denominator for AETR calculation purposes, the outcome would be an AETR exceeding 48%.[941] Accordingly, under a CBIT, the AETR significantly exceeds the statutory tax rate of 25%. This effect can be appreciated should one recognize that financing costs are actual costs. That is, at least to the extent it does not concern intra-group debt financing arrangements which are typically recognized for tax calculation purposes under the separate entity approach. Third parties, such as banks, actually collect interests due (or sell the collateral if the debtor defaults on its payments). The post-tax nominal return on the invested equity capital, 3.375%, equals 51.9% of the pre-tax nominal return on the invested equity capital, 6.5%.[942] The difference between the pre-tax return, 6.5% and the post-tax return, 3.375%, being 3.125%, sometimes referred to as the 'tax-wedge', equals the employed tax rate of 25% multiplied by Johnson's operational return on its investment.[943] The difference between the amount of tax payable under the CBIT referred to in this section, i.e., €125, and the amount of tax payable under the conventional corporate income tax, i.e., €65, can be understood as being the effect of broadening the taxable base by denying the tax-deduction of the interest payment of €240. This interest deduction limitation accounts for the increase in tax payable with €60 (i.e., from an amount of tax payable of €65 until €125).[944]

If one were to acknowledge that the pre-tax business cash flow should be taken into consideration as denominator for AETR calculation purposes, i.e., the earnings exceeding the normal market rate of return, which in this case account for a mere €100, then the AETR would be relatively higher. Under that point of reference, the AETR calculation produces an AETR equal to 125%.[945] Johnson's excess earnings of €100 would be completely taxed away. Johnson pays more tax than he actually earns. Accordingly, the above statutory AETR under a CBIT should be considered unfair provided that one recognizes that savings, or the remuneration for the provision of capital, should not be taxed under a business income tax as such a tax should merely tax the remuneration for the production factor of enterprise. That is, just as the above statutory rate under a conventional corporate income tax should be considered unfair for this reason. This plainly holds up since one does not get what one sees, i.e., an effective tax imposed at a rate equal to the statutory tax rate. This *a fortiori* holds true in cases where states tax savings under a portfolio investment income tax *de facto* producing an economic double taxation of savings income.[946]

Tax wedge affects investment location decisions

This being said, moreover, analogue to a conventional corporate income tax, a CBIT only produces AETRs of 48% (or 125% when employing pre-tax excess earnings as the denominator), in the event that the depreciation and the like employed for tax calculation purposes corresponds with the economic depreciation of Johnson's investment.[947] As with conventional corporate income taxes, under CBITs the wedge between pre-tax and post-tax

[940] Again, see for a comparison Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, who refer to concerns as to whether it is suitable to find a proper measure of profit to use as the denominator.
[941] 125 / 260 * 100% = 48.1%.
[942] 1 – 125 / 260 * 100% = 51.9%. Alternatively: 0.03375 / 0.065 = 0.519.
[943] 6.5% – 3.375% = 0.25 * 500/4,000. Accordingly: $v - v_{CBIT} = t.\{[\rho + (1 - d)] / (1 - \alpha)]$.
[944] 125 – 65 = 60 = 0.25 * 240. Accordingly: $v_{CBIT} - v_C = t.r.\alpha$.
[945] 125 / 100 * 100% = 125%.
[946] The question of whether savings should be taxed in the first place, as said, is not considered in this study. Please note that the proposal of the US Department of the Treasury recognized the capital tax element in the CBIT. The proposal is accompanied by an abolition of personal taxes on capital.
[947] d = 1.

rate of returns would grow bigger or smaller would tax depreciation and economic depreciation mutually diverge. Dependent on facts and circumstances the AETR would fluctuate accordingly. Divergences between tax depreciation and economic depreciation consequently would affect location investment decisions in a manner akin to the investment decision distortions as already recognized in the above section 5.4.2.2 in respect of conventional corporate income tax systems. That would feed the 'race to the bottom' referred to in that above section.

5.5.2.3 Financing Discrimination Issues Mitigated

Second, the numbers forwarded in the cash flow statement above tells us something about the effects of financing decisions. It shows that there is a bright side to the CBIT.

The adoption of a CBIT would resolve the financing discrimination issues that arise under a conventional corporate income tax system as explained earlier. The CBIT is neutral as regards the decision of how to finance a particular investment. Namely, both interest payments, which in this case equal €240, as well as the opportunity costs of capital, which in this case equal €160, constitute non-deductible items. Accordingly, the costs of financing, regardless of whether debt or equity financing has been employed, do not affect the taxable base and, therefore, due to the nature of CBIT, cannot influence the financing decisions accordingly. Hence, a CBIT is neutral towards financing decisions. Johnson would be subject to a tax liability equal to €125 regardless of whether the investment in the dinghy selling activities is financed with debt, equity, or a combination thereof.

Contrary to a conventional corporate income tax, a CBIT renders the financing decision immaterial for tax calculation purposes. Had Johnson financed the dinghy sales activity entirely with debt,[948] the CBIT would have produced a tax liability of €125 as well (instead of a taxable amount of €25 which would be the case under a conventional corporate income tax).[949] The tax payable under a CBIT would also have accounted for €125 had Johnson financed its investment entirely with equity.[950-951] Accordingly, the CBIT would not subsidize debt financing relative to equity financing as is the case under conventional corporate income tax systems today (please note that Johnson, under a conventional corporate income tax, would be liable to pay €125 tax had he financed the dinghy sales activity entirely with equity). The adoption of CBIT would entail that the current tax incentives toward excessive debt financing would disappear.

The introduction of a CBIT would accordingly render superfluous all interest deduction limitations that can be currently found throughout virtually all states' international tax systems with the stroke of a pen. In addition, the same holds true in respect of the ongoing quest to draw the dividing line between debt and equity financing for conventional corporate income tax calculation purposes. If no distinctions are made, there is no need to draw dividing lines. To that extent, the CBIT would make life quite easy.

5.5.2.4 Marginal Effective Tax Rates; the Price: Distortions at the Margin

The life easing financing neutrality feature of a CBIT, however, comes with a price. As mentioned, the CBIT's broad taxable base triggers above statutory AETRs. This inequitable feature of the CBIT's non-recognition that the costs of capital economically are actual costs incurred could of course be mitigated by reducing statutory rates.

Such an equity enhancing tax rate reduction, however, would not help things when looking at fairness in terms of marginal effective tax rate ('METR') calculations and investment decisions at the margin. If seen from that perspective, the CBIT proves inequitable and distortive as the

[948] $\alpha = 1$.
[949] 0,25 * (500) + (10,000 – 10,000) = 125.
[950] $1 - \alpha = 1$ ($\alpha = 0$).
[951] 0.25 * (500) + (10,000 – 10,000) = 125.

adoption of a CBIT would prove distortive at the margin. Frankly put, CBITs distort marginal investment decisions. Please let me elaborate on this.

The CBIT taxes excess earnings as well as the costs of debt capital and the opportunity costs of equity capital. Due to the non-deductibility of the costs of debt and equity capital for tax calculation purposes, the actual level of capital costs is higher in comparison with a no tax environment – and the environment under a corporate income tax which allows for the tax-deduction of interest payments. [952]

So that is the third thing the numbers, forwarded in the cash flow statement under a CBIT set forth in the above, tell us. They tell us something about METRs. As said, these are calculated by measuring the tax burden with respect to an additional unit of pre-tax income.[953]

Let us calculate METRs to illustrate things. Under the CBIT, in our example, a marginal item of income would be taxed at an excessively high rate.[954] While the pre-tax return on Johnson's investment in our example exceeds the normal market return rate of 4% with 250 base points, the pre-tax return rate equals 6.5%, the post-tax return rate drops 62.5 base points under the normal market rate return or opportunity costs of capital, i.e., to 3.375%. Accordingly, Johnson's profitable investment turns out to render a loss.[955]

The CBIT starkly pushes on the costs of capital at the margin, consequently reducing the inflow of capital. Moreover, tax rate reductions do not resolve this effect of pre-tax profitable returns and post-tax loss rendering returns. The CBIT's increasingly excessive tax rate towards the margin renders profitable investments loss-making at the margin, having the effect of making marginal investment decision substantially less attractive relative to a no tax environment. This holds true, irrespective of the employed tax rates. Had Johnson's investment, for instance, yielded a pre-tax return of 4.01%, a business cash flow in our example of €1, a CBIT imposed at rate of, for example, 5% would produce a tax liability equal to €20.05.[956] A tax rate equal to a staggering 2,005%! A pre-tax return of 4.0%, i.e., the marginal investment producing a marginal income equal to nil, would entail a tax liability of €20. That would produce an infinite METR ('∞').

5.5.3 We need something else…

These pretty straightforward examples illustrate the severe distortions at the margins that CBITs cause and with that reveals the unfair features of the CBIT. The CBIT would resolve the financing discrimination issues that appear in conventional corporate income taxation. However, the price to be paid, i.e., the excessive AETR and METR effects, in my view, would be too high. Solutions for the problems that occur under the conventional corporate income tax base should be sought elsewhere.

Notably, as the CBIT proves unfair already when it concerns direct investments, there is no need to further explore its potential effects in cases of indirect investments through subsidiaries or investments in minority shareholders' interests. Let us proceed and consider some alternative tax bases.

Worth noting finally is that it has been argued in the literature that legislative steps towards the introduction of CBIT-like properties into the international tax system would entail the

[952] See Ruud A. de Mooij et al, 'An applied analysis of ACE and CBIT reforms in the EU', 18 *International Tax and Public Finance* 93 (2011), at 93-120 who forward similar remarks.
[953] See Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 73.
[954] This effect may be recognized in the formula component $[(\rho - r) - t.\rho] / (1 - \alpha)$ forwarded in footnote reference 938.
[955] Also De Mooij and Devereux recognize this unfair property of the CBIT. See Ruud A. de Mooij et al, 'An applied analysis of ACE and CBIT reforms in the EU', 18 *International Tax and Public Finance* 93 (2011), at 93-120. The authors consequently argue an introduction of a CBIT feature within an European Union-wide business income tax to be less efficient relative to an ACE.
[956] 0.05 * 401 = 20.05.

introduction of a harmful tax measure.[957] For instance, the 'mandatory group interest box regime', once proposed by the Netherlands' government providing for an 80% exemption of intra-group interest payments, had been withdrawn amongst others for fears of being labeled as 'harmful tax competition'. It was thought that the introduction of such a regime would trigger foreign retaliatory legislative responses, e.g., the application of anti-abuse measures like interest deduction limitations.[958] The conceptually murky label 'harmful tax competition' has been used in the literature basically by referring to the regime's differential approach towards debt financing relative to the approach adopted under a conventional corporate income tax. In my view such reasoning is analytically invalid, as it would render all divergences from the conventional corporate income tax to constitute 'harmful tax competition': *It differs and, therefore, is wrong*.

5.6 Towards fairness: the allowance for corporate equity

5.6.1 General remarks

5.6.1.1 An ACE taxes rents

Let us proceed with the so-called 'allowance for corporate equity ('ACE').[959] The ACE basically operates in a manner similar to a conventional corporate income tax with one vast difference: a tax-deduction for the opportunity costs of equity capital. Accordingly, both the remunerations for the provision of debt capital (interest payments) and equity capital (i.e., the opportunity costs of capital) are tax-deductible for tax calculation purposes. This basically entails that normal market rate returns on equity investments are not taxed.

The financing discrimination issue under a conventional corporate income tax is sought to be mitigated by granting equity financing the exact same tax treatment as debt financing. The mechanism used is the making available of a tax deduction for equity financing arrangements. That is, in addition to the recognition of tax-deductible interest payments for tax calculation purposes.

5.6.1.2 Creating tax-parity in financing by granting deduction for equity financing

Accordingly, the ACE operates exactly opposite of the CBIT. As both the remunerations for the provision of debt capital and equity capital are tax-deductible, merely the remunerations for the provision of the production factor of enterprise are taken into consideration for tax calculation purposes. This typical feature of the ACE accordingly has the effect of the tax to adopt a significantly narrower taxable base in comparison with both the conventional corporate income tax (which recognizes debt financing, yet disregards equity financing for tax calculation purposes) and CBIT (which recognizes neither debt financing nor equity financing arrangements for tax calculation purposes). The tax base under an ACE is basically calculated by merely making reference to the investor's excess earnings (business cash flow) or economic rent.

There are some real world examples of countries adopting approaches akin to ACEs. Currently, Belgium applies a variant of the mechanism under the so-called 'notional interest

[957] See, for instance, Rita Szudoczky et al, 'Revisiting the Dutch Interest Box under the EU State Aid Rules and the Code of Conduct: When a 'Disparity' Is Selective and Harmful', 38 *Intertax* 260 (2010), at 260-280.
[958] See the letters of the State Secretary for Finance of December 5, 2009, No. DB2009/674 M and April 14, 2011, No. AFP/2011/248U.
[959] The proposals for an ACE originated in the early 1990s. See the proposal of the Capital Taxes Committee of the Institute for Fiscal Studies, *Equity for Companies: A Corporate Tax for the 1990s*, London (1991). See also Michael P. Devereux et al, 'A general neutral profits tax', 12 *Fiscal Studies* 1 (1991), at 12-15. The ACE has been based on an earlier proposal for a 'capital cost deduction' forwarded by Robin Broadway et al, 'A general proposition on the design of a neutral business tax', 24 *Journal of Public Economics* 231 (1984), at 231-239. For an analysis, reference is made to Ruud A. de Mooij et al, 'An applied analysis of ACE and CBIT reforms in the EU', 18 *International Tax and Public Finance* 93 (2011), at 93-120. See for some further discussion
Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008).

deduction regime'.[960] The 'notional interest deduction' provides for a yearly 'fictitious' tax deduction basically equal to the respective taxpayer's equity capital multiplied with the published interest rate on long-term (10-year) Belgian government bonds. In the Netherlands, the so-called '*Study Group Tax System',* a Dutch government-appointed advisory committee, recognizes the ACE to constitute a founding feature of an envisaged Dutch profit tax system of the future.[961] Moreover, some real world experience with ACE-style tax reforms has been gained in Austria, Croatia, Brazil and Italy.[962]

5.6.2 The effects involving a direct investment

5.6.2.1 Assessing the investment returns of 'Ben Johnson Dinghy Selling Company'

The operation of an ACE can be illustrated best by means of a numerical example. Let us return to our taxpayer Johnson and its dinghy business activities. As said, Johnson invests in a dinghy sales activity directly. The tax rate again equals a linear 25%. Under an ACE, the effects are as follows (fig. 55):

Fig. 55. Johnson's ACE calculation

	Period 1	***Period 2***
Johnson's ACE calculation		
Earnings		
Gross Earnings ('EBITDA')	0	+ 10,500[963]
Aggregate	0	+ 10,500
Costs		
Financing Expenses (interest)	0	– 240[964]
Opportunity costs of capital	0	– 160[965]
Depreciation	0	– 10,000[966]
Aggregate	0	– 10,400[967]
Tax Levy		
Aggregate (Taxable Amount)	0	+ 100[968]
Tax* (25%)	0	+ 25[969]

***)** A tax preceded by a '+' sign represents an amount of tax payable.

Johnson's business activities produce the following business cash flows (fig. 56):

Fig. 56. Johnson's Cash Flow Statement

	Period 1	***Period 2***
Johnson's Cash Flow Statement		
Real Transactions ('R')		
Investment	– 10,000[970]	
Gross Return on Investment		+ 10,500[971]

[960] The relevant provisions of the legislation in force in Belgium are contained in Articles 205bis through 205novies of the Income Tax Act ("Wetboek van de inkomstenbelastingen 92").
[961] The *Study Group Tax System* forwarded its conclusions in its report entitled *'Continuïteit en vernieuwing. Een visie op het belastingstelsel' (Studiecommissie Belastingstelsel)*. See the letter of the State Secretary of Finance to the Dutch Lower House of Parliament to the Dutch Lower House of Parliament of April 7, 2011 ("Brief van de Minister van Financiën aan de Voorzitter van de Tweede Kamer der Staten-Generaal van 7 april 2010, Kamerstukken II, vergaderjaar 2009-2010, 32140, nr. 4"), at 1. The report has been attached to this letter.
[962] See for some discussion Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, and Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), at 47-48. For an overview of practical experiences, see Alexander Klemm, 'Allowances for Corporate Equity in Practice', 53 *CESifo Economic Studies* 229 (2007), at 229-262, and Francesco Massimi et al, 'Real-World ACE Reforms and the Italian Experience. Towards a General Trend?', 40 *Intertax* 632 (2012, No. 11), at 632-642.
[963] 1 + ρ.
[964] – α.r.
[965] – (1 – α).r.
[966] – d.
[967] – r – d.
[968] (500 – 240 – 160) + (10,000 – 10,000) = 100. Accordingly: (ρ – r) + (1 – d).
[969] 0.25 * [(500 – 240 – 160) + (10,000 – 10,000)] = 25. Accordingly: t.[(ρ – r) + (1 – d)].
[970] – 1.

Aggregate	– 10,000	+ 10,500
Financial Transactions ('F')		
Debt Issuance	+ 6,000[972]	
Repayment Principal Amount		– 6,000[973]
Interest Paid		– 240[974]
Aggregate	+ 6,000	– 6,240[975]
Tax Levy		
Tax*[)] (25%)	0	+ 25[976]
Aggregate	– 4,000[977]	+ 4,235[978]

*[)] A tax preceded by a '+' sign represents an amount of tax payable.

The net outward bound cash flow in period 1 equals €4,000, an amount equal to the invested equity capital. The transactions in period 1 again do not constitute a taxable event under an ACE. The ACE shares this feature with both the conventional corporate income tax and the CBIT. The net inbound cash flow in period 2 nevertheless alters. This holds true in comparison with a no tax environment, the scenario under a conventional corporate income tax and the scenario under the CBIT. This time, the inflow in period 2 equals €4,235. The net post-tax return to the invested equity capital ('v_{ACE}') equals €235, a percentage of 5.875.[979] What does this tell us? Again, the numbers tell us three things (see sections 5.6.2.2, 5.6.2.3, and 5.6.2.4).

5.6.2.2 Equal to Statutory Average Effective Tax Rates

First, it tells us something about the AETR under an ACE. The ACE does not tax the entire nominal return to equity. Rather, it merely taxes excess earnings, the investor's economic rent.[980] Both the costs of debt capital (€240) as well as the opportunity costs of equity capital (€160) constitute tax-deductible items. Consequently, it only taxes the excess earnings of, in this case, €100. Accordingly, the application of an ACE produces a tax payable of €25. The difference between the amount of tax payable under the ACE referred to in this section, i.e., €25, and the amounts of tax payable under the CBIT (€125) and the conventional corporate income tax (€65), can be understood as being the effect of narrowing the taxable base by granting tax deductions for both debt capital (€240) and equity capital (€160) remunerations. The deduction for the equity component accounts for the decrease in taxes payable relative to a conventional corporate income tax system of €40 (i.e., from an amount of tax payable of €65 until €25).[981] In addition, as the costs of capital include the inflation component, an ACE produces a substantive foundation concept for taxable profit calculation purposes. This is contrary to both a conventional corporate income tax system and the CBIT. Both tax nominal investment returns.

In my view, these features of an ACE are pivotal in distinguishing it from conventional corporate income tax systems and the CBIT as the ACE provides the first tax base foundation concept forwarded in this chapter that seeks to tax the actual income derived in return for the provision of the production factor of enterprise. Accordingly, it is the first tax base foundation concept seeking to fully appreciate the underlying S-H-S concept of income to the extent it

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[971] 1 + ρ.
[972] α.
[973] – α.
[974] – α.r.
[975] – α.(1 + r).
[976] t.[(ρ – r) + (1 – d)].
[977] – (1 – α).
[978] (1 – α) + (ρ – α.r) – t.(ρ – r) – t.(1 – d).
[979] (4,235 / 4,000) – 1 = 0.05875. Accordingly: $v_{ACE} = [(1 – \alpha) + (\rho – \alpha.r) – t.(\rho – r) – t.(1 – d)] / (1 – \alpha) – 1 = (1 – t).(\rho – r) / (1 – \alpha) – t.(1 – d)$ I/ $(1 – \alpha) + r$. It is noted that the formula corresponds with its equivalent under the modified R-CFT set forth in section 7.2.3 with the exception of the tax depreciation component, as $v_{modR\text{-}CFT} = (1 – t).(\rho – r) / (1 – \alpha) + r$. The same holds true under the modified R+F-CFT set forth in section 7.3.3 with the same exception, as $v_{modR+F\text{-}CFT} = (1 – t).(\rho – r) / (1 – \alpha) + r$. Moreover, reinforcing the R+F-CFT with tax depreciation in a manner as set forth in section 7.3.4., renders it identical to the ACE, as $v_{modR+F\text{-}CFTdepreciation} = (1 – t).(\rho – r) / (1 – \alpha) – t.(1 – d) / (1 – \alpha) + r$.
[980] This effect may be recognized in the formula component $(1 – t).(\rho – r) / (1 – \alpha)$ forwarded in the previous footnote reference 979.
[981] 65 – 25 = 40 = 0.25 * 160. Accordingly: $v_C – v_{ACE} = t.r.(1 – \alpha)$.

concerns income derived from carrying on business activities (opposite to labor income and savings income).

Now let us calculate AETRs. Again, AETRs are calculated by dividing the tax payable (numerator) by the pre-tax income (denominator).[982] The tax payable to be adopted in the numerator equals €25. With respect to the amount to be adopted in the denominator, the remarks referred to in the above should be repeated. Johnson's pre-tax return of €260, as said, comprises of two components. The first component amounting to €100 refers to the excess earnings, the remuneration for the production factor of enterprise. The second component amounting to €160 refers to the normal market return rate on the investment (i.e., the opportunity costs of capital), the remuneration for the equity capital provided. Again, the question arises as to which of these amounts should be taken into consideration?[983]

Would the pre-tax nominal return to equity, €260, be adopted as the denominator for AETR calculation purposes, the outcome would be an AETR roughly equal to 10%.[984] Viz., the post-tax nominal return on the invested equity capital, 5.875%, roughly equals 90% of the pre-tax nominal return on the invested equity capital, 6.5%.[985] That could trigger one to jump to the conclusion that ACEs produce below statutory AETRs. Or are we once again comparing apples to oranges?

If one were to acknowledge that the pre-tax business cash flow, i.e., the earnings exceeding the normal market rate of return, which in this case account for €100, should be taken into consideration as denominator for AETR calculation purposes, the AETR would increase in comparison with the 10% AETR calculation set forth in the above paragraph. This effect can be appreciated should one recognize that financing costs, including the opportunity costs of equity capital, are actual costs. Taking that starting point for AETR calculation purposes, the AETR on Johnson's business cash flow equals 25%.[986] The difference between the pre-tax return, 6.5% and the post-tax return, 5.875%, being 0.625%, equals the employed tax rate of 25% multiplied with Johnson's economic rent derived from its investment in the dinghy distribution business.[987] Put forward otherwise, Johnson's pre-tax return exceeds the normal market return rate of 4% with 250 base points with a return of 6.5%. Johnson's post-tax return equals 5.875%. That amount exceeds the normal market return rate of 4% with 187.5 base points. The difference between pre-tax and post-tax return rates equals 62.5 base points, and accordingly produces an AETR of 25%.[988]

Consequently, under proper AETR calculations, the ACE produces equal to statutory AETRs of, in this case, 25%. Johnson pays the same amount of tax he actually earns. Accordingly, provided that one recognizes that savings, or the remuneration for the provision of capital, should not be taxed under a business income tax as such a tax should merely tax the remuneration for the production factor of enterprise, the equal to statutory AETR under an ACE should enhance fairness relative to conventional corporate income tax and the CBIT. The fairness of the situation is plain to see, since one gets what one sees, i.e., an effective tax imposed at a rate equal to the statutory tax rate. Again, this *a fortiori* holds true in cases where states tax savings under a portfolio investment income tax *de facto* producing an economic double taxation of savings income.[989]

Investment location decisions in the presence of AETR differentials

[982] See Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 73.
[983] See for a comparison Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, who refer to concerns as to whether it is suitable to find a proper measure of profit to uses as the denominator.
[984] 25 / 260 * 100% = 10%.
[985] 1 – 25 / 260 * 100% = 90%. Alternatively, 0.05875 / 0.065 = 0.90.
[986] 25 / 100 * 100% = 25%.
[987] 0.065 – 0.05875 = 0.25 * 100/4,000. Accordingly: $v - v_{ACE} = t.(\rho - r).(1 - d) / (1 - \alpha)$.
[988] 62.5 / 250 * 100% = 25%.
[989] The question of whether savings should be taxed in the first place is not considered in this study.

This being said, moreover, analogue to both a conventional corporate income tax and the CBIT, the ACE only produces AETRs of 25% in the event that the depreciation employed for tax calculation purposes corresponds with the economic depreciation of Johnson's investment.[990] As with conventional corporate income tax systems and CBITs in this respect, a wedge between pre-tax and post-tax rates of return would emerge, growing bigger or smaller to the extent that tax depreciation and economic depreciation mutually diverge, for instance due to the adoption of tax incentives such as depreciation allowances and tax holidays. Dependent on facts and circumstances, the AETR would fluctuate accordingly. Divergences between tax depreciation and economic depreciation, consequently, would seem to affect location investment decisions in a manner akin to the investment decision distortions as already recognized in the above in respect of conventional corporate income tax systems. Accordingly, states would seem to be in need to adopt tax depreciation mechanisms that (aim to) correspond with economic depreciation to mitigate these effects.

However, this being said, the effects could be considered less significant in present value terms.[991] At least, to the extent it concerns mutual differences between tax depreciation and economic depreciation in terms of the pace in which depreciation is recognized (i.e., temporal differences). That is because the accelerated tax depreciation relative to the economic depreciation would reduce not only the tax bookkeeping value of the respective asset, but also the taxpayer's equity in respect of which the ACE is calculated against in later years. Accordingly, accelerated tax depreciation reduces the ACE granted in later years. This offsets the tax benefits from the accelerated tax depreciation, which entails the present values of depreciation and ACE allowances to be independent of the rate against which assets are written-off in tax bookkeeping.

This holds true, in addition to the reality that income currently is attributed to taxing jurisdictions by means of origin based profit allocation factors. The mere adoption of an ACE feature would not change investment location distortions.[992] Consequently, mutual divergences between AETRs under ACE based corporate tax systems could not put an end to the 'race to the bottom' referred to in the above. Accordingly, the ACE would not resolve things in the geographical tax base allocation area. The attribution of profits to taxing jurisdictions is recognized and further discussed as an isolated issue in Chapter 6.

5.6.2.3 Financing Discrimination Issues Mitigated

Second, the numbers forwarded in the cash flow statement above tells us something about the effects of financing decisions.

The adoption of an ACE would mitigate the financing discrimination issues that arise under a conventional corporate income tax as explained earlier. The ACE operates neutral to a great extent as regards the decision of how to finance a particular investment. Namely, both interest payments, which in this case equal €240, and the opportunity costs of capital, which in this case equal €160, constitute tax-deductible items. As is also the case with the CBIT, the ACE resolves the financing discrimination issue. Yet it reaches this outcome by exact opposite means. Contrary to the CBIT mechanism, the costs of financing, regardless of whether debt or equity financing has been employed, affect the taxable base and, therefore, by the nature of the ACE, cannot influence the financing decisions accordingly. Had Johnson financed the dinghy sales activity entirely with equity,[993] the tax payable under an ACE would have

[990] d = 1.
[991] See Robin Broadway et al, 'A general proposition on the design of a neutral business tax', 24 *Journal of Public Economics* 231 (1984), at 231-239. See also Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, as well as Ruud A. de Mooij et al, 'An applied analysis of ACE and CBIT reforms in the EU', 18 *International Tax and Public Finance* 93 (2011), at 96, as well as Michael P. Devereux et al, 'A General neutral profit tax', 12 *Fiscal Studies* 1 (1991), at 9.
[992] See also Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), at 48.
[993] 1 – α = 1 (α = 0).

accounted for €25[994] (instead of a taxable amount of €125 which would be the case under a conventional corporate income tax).[995] Had the dinghy sales activity entirely been financed with debt,[996] the ACE would also have produced a tax liability of €25.[997] Johnson would be subject to a tax liability equal to €25 regardless of whether the investment in the dinghy selling activities is financed with debt, equity or a combination thereof. Hence, the ACE renders the financing decision immaterial for tax calculation purposes making this decision tax neutral in this respect. It would not subsidize debt financing relative to equity financing as is the case under conventional corporate income tax systems today. The adoption of an ACE would therefore entail that the current tax incentives for excessive debt financing would disappear, or at least be robustly mitigated. The introduction of an ACE, accordingly, would render superfluous with the stroke of a pen all interest deduction limitations that can be currently found throughout the international tax regime. Thin capitalization issues would be rendered moot.

It should be mentioned, however, that the tax-deduction for the opportunity costs of capital to be laid down in the tax legislation would equal a (perhaps annually set) fixed amount, e.g., the return on a long-term government bond with a mark-up for economic risk incurred. To the extent that this fixed amount does not correspond with actual normal return rates – a necessary effect of the adoption of a fixed tax-deduction – differences between debt and equity financing in terms of tax burdens imposed would remain to occur. As mentioned in the above section 5.3.4, it would be quite difficult to decide on a 'proper' interest rate for ACE purposes. Each amount chosen would constitute a proxy and would be arbitrary to some extent. However, if compared with current conventional corporate income taxation and its scope of subsidizing debt financing relative to equity financing, these differences in tax treatment between debt and equity financing under an ACE would be substantially mitigated.

This particularly holds true to the extent that the tax-deduction is closely monitored and occasionally set-off against market return rates on low-risk debt financing arrangements to guarantee that potential arbitrage opportunities would remain inconsequential. Notably, solutions for these remaining divergences between debt and equity financing may alternatively be sought in granting a deduction for both equity and debt financing arrangements, as a proxy, i.e., regardless of actual interest payments agreed upon. Such a mechanism is typically referred to as a 'capital cost deduction' or 'allowance for corporate capital' ('ACC').[998] The ACC would operate conceptually similar to an ACE. It would bring the exact same tax treatment of debt and equity financing, but by means of a tax-deductible amount corresponding with the normal market return rate on the respective firm's entire capital, i.e., the firm's equity capital and debt capital combined. The ACC is not further discussed.

It is true that, under an ACE, one would still be required to draw the administrative dividing line between debt and equity financing for tax calculation purposes. However, due to the considerable mitigation of the financing discrimination issue, the incentive involving the drawing of such a line in terms of tax burden consequences and opposite tax revenue consequences would be strongly reduced.

It may for instance suffice to draw the line by reviewing the question of whether the funds are made available under the (legal) obligation to materially repay the principal amount within a period of say 20 years.[999] An affirmative answer could entail the qualification of the financing

[994] 0.25 * (500 – 400) + (10,000 – 10,000) = 25.
[995] 0.25 * (500) + (10,000 – 10,000) = 125.
[996] α = 1.
[997] 0.25 * (500 – 400) + (10,000 – 10,000) = 25.
[998] Reference can be made to Robin Broadway et al, 'A general proposition on the design of a neutral business tax', 24 *Journal of Public Economics* 231 (1984), at 231-239, suggesting a 'capital cost deduction'. See also, for instance, Ruud A. de Mooij et al, 'An applied analysis of ACE and CBIT reforms in the EU', 18 *International Tax and Public Finance* 93 (2011), at 93-120, who refer to the suggestions of Broadway and Bruce to introduce an allowance for corporate capital.
[999] For instance, in the Netherlands the dividing line in taxation to distinguish debt from equity is the material obligation to repay the principle amount within a period not exceeding 50 years. A subordinated profit participating loan issued under a term exceeding 50 years is considered an equity contribution for corporate income tax purposes.

arrangement as debt entailing tax deductible interest payments; a negative answer would then entail the qualification of the financing arrangement as equity to trigger the fixed tax-deduction to account for the opportunity costs of capital. Contract law typically employs similar distinctions. Such a clear-cut dividing line could prove sufficient since the incentives to qualify respective financing arrangements as debt or equity would be strongly reduced. The gain or loss in terms of tax costs seems limited. So why seek the borderline and create legal uncertainty? If the need to distinguish is inconsequential, the same may hold true regarding the accuracy of the lines drawn. The ACE would make life easier.

5.6.2.4 Marginal Effective Tax Rates are nil

And things would get better. Contrary to the CBIT, the life easing financing neutrality feature of an ACE does not come with a price. At least that is, not in addition to the administrative requirements for tax calculation purposes to define the opportunity costs of equity capital, the fixed tax-deductible amount, and the drawing of the dividing line between debt and equity (e.g. by means of looking into the requirement to repay the principal amount).

So that would be the third matter the numbers forwarded in the cash flow statement under an ACE tell us. In addition to the ACEs feature that AETRs correspond with statutory tax rates, METRs are nil.[1000] This is opposite to the CBIT where METRs, as explained in the above, are sky-rocketing. Frankly put, ACEs do not distort marginal investment decisions as one would not pay tax at the margin. Accordingly, an ACE would not prove inequitable and distortive at the margin. Please let me elaborate on this.

As mentioned, the ACE does not tax the entire nominal return to equity. Rather, it merely taxes excess earnings, or the investor's economic rent. Due to the deductibility of both the costs of debt and equity capital for tax calculation purposes, the actual level of capital costs is equal to the costs of capital in a no tax environment (and lower in comparison with the environments under a CBIT or the conventional corporate income tax). Let us calculate METRs to illustrate things. Under the ACE, in our example, the METR equals 0%. Had Johnson's investment, for instance, yielded a pre-tax return of 4.01%, a business cash flow in our example of €1, an ACE imposed at a 25% rate would produce a tax liability equal to €0.25.[1001] A pre-tax return of 4.0%, i.e., the marginal investment producing a marginal income equal to nil, would entail a tax liability of €0 also.[1002] That would produce the 0% METR.[1003]

5.6.2.5 Arguments for Further Exploration…

These straightforward examples illustrate the fairness enhancing effects that ACEs produce: equal to statutory AETRs, financing neutrality and nil METRs. This provides some arguments for further exploration of the ACE as a foundation concept for taxable profit calculation purposes.

Before leaping towards the effects under indirect investments, some remarks should be forwarded first. In comparison with conventional corporate income taxation and the application of the CBIT, tax revenues under an ACE could be considered quite moderate. In our example, under the ACE Johnson would be liable to pay €25 tax while the conventional corporate income tax would produce a tax liability of €65. That is, at least to the extent that Johnson would fail to recognize the debt financing incentive under conventional corporate income taxation and would not finance its investment in the dinghy selling activities entirely with debt. That would produce a €25 corporate income tax liability.

See Maarten F. de Wilde et al, 'The Netherlands – Key practical issues to eliminate double taxation of business income', in International Fiscal Association, *Cahiers de droit fiscal international* (2011) 447, at section 2.1.3.

[1000] See for a comparison Ruud A. de Mooij et al, 'An applied analysis of ACE and CBIT reforms in the EU', 18 *International Tax and Public Finance* 93 (2011), at 93-120 who forward similar remarks.

[1001] 1.00 * 0.25 = 0.25.

[1002] 0.00 * 0.25 = 0.00.

[1003] See also Bond and Devereux who demonstrate the ACE's neutrality at the margin in Stephen R. Bond et al, 'Generalised R-based and S-based taxes under uncertainty', 87 *Journal of Public Economics* 1291 (2003), at 1291 – 1311.

In addition, the CBIT would produce tax payable of €125 rendering the pre-tax profitable investment as a loss at the margin post-tax. The reduced revenue effects caused by the narrow taxable base (at least, that is relative to the conventional corporate income tax) are sometimes recognized as a disadvantage of the ACE.

The policy requirements of maintaining tax revenues would accordingly seem to render tax rate increases necessary. That is the argument at least. It is sometimes said in practice that this would make the respective taxing jurisdiction less attractive for foreign investments, if multinationals base their location decisions on statutory tax rates.[1004] I doubt whether that would really be the case. First, I feel it hard to believe that directors of multinational firms would fail to recognize that high tax rates with narrow tax bases could produce lower AETRS than low tax rates with broad tax bases (or vice versa). I would tend to argue that CFOs are very well acquainted with the concept that taxation is more than just a tax rate. This may particularly be considered true since international tax practice reveals the presence of technically complex legal structures, such as intra-group hybrid financing structures, which multinational firms implement for tax optimization reasons. Second, it is no secret that, under conventional corporate income taxation, AETRS and statutory tax rates mutually diverge to a great extent. This is sometimes referred to as base erosion. It is sometimes heard in tax practice as a rule of thumb that perhaps up to 60% of a multinational firm's profits may effectively escape corporate taxation if business is structured legally in a tax-optimized manner.[1005] A tax gap of such an extent would render the statutory 25% tax rates to effectively tax at a 10% rate. That percentage comes close to the (though analytically flawed) rough 10% AETR calculation under an ACE as set forth in the above; see section 5.6.2.2. If seen from that perspective, AETRs under an ACE may not necessarily entail significant declines in revenue collection.[1006]

Worth noting finally is that, in the past, some have considered that the taking of steps by countries toward an ACE to produce harmful tax competition. For instance, the Belgian 'notional interest deduction' referred to in the above has once, i.e., at least implicitly, been labeled as 'harmful tax competition' by the Netherlands government in 2007.[1007] In my view, this is quite odd as the ACE is the first to provide a fair foundation concept of taxable income, since it actually seeks to tax economic rents and mitigate the financing discrimination issue.

Again, the label 'harmful tax competition' seems to have been placed, basically by referring to the regime's different approach relative to the conventional corporate income tax. In my view such reasoning is analytically invalid as it would render all divergences from the conventional corporate income tax to constitute 'harmful tax competition': *It differs and, therefore, it is wrong*. Moreover, the so-called '*Study Group Tax System',* a Dutch government-appointed advisory committee, recognizes that the ACE constitutes a founding feature of an envisaged Dutch profit tax system of the future.[1008] The 'harmful tax competition' label, posted by the

[1004] Empirical research, which, notably, I did not came across in my research, could verify such a hypothesis. See for a comparison, Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264. The authors set forth that it might be expected that multinationals, in addition to reviewing statutory tax rates, base their decisions on the allowances and deductions available in a jurisdiction.

[1005] That is, although 'it is difficult to reach solid conclusions about how much base erosion and profit shifting actually occurs' in practice. See OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing, 12 February 2013, at Chapter 2, also for overviews of corporate tax receipts data.

[1006] Unfortunately, there seem to be no clear-cut empirical studies available verifying economic implications of ACE-style reforms. See for a comparison Ruud A. de Mooij et al, 'An applied analysis of ACE and CBIT reforms in the EU', 18 *International Tax and Public Finance* 93 (2011), at 93-120.

[1007] Reference can be made to Dutch Parliamentary history. See, for instance, Parliamentary papers of the Dutch Lower House of Parliament (Kamerstukken II, 2006-2007, 30572, nr. 13 'Wetgevingsoverleg' 18 September 2006), at 43, where the Netherlands government referred to Belgium, for illustration purposes, as low-taxing jurisdiction for the purpose of applying the 'subject-to-tax-test'. The low tax impost in Belgium is explained as a consequence of the notional interest deduction limitation in place in Belgium. This may trigger the application of the 'switch-over' to the indirect credit mechanism in the Netherlands regarding so-called 'low-taxed portfolio participations'.

[1008] The *Study Group Tax System* ("Studiecommissie Belastingstelsel") forwarded its conclusions in its report entitled 'Continuïteit en vernieuwing. Een visie op het belastingstelsel'. See the letter of the State Secretary for Finance to the Dutch Lower House of Parliament to the Dutch Lower House of Parliament of April 7, 2011 ("Brief van de Minister van Financiën aan de Voorzitter van de Tweede Kamer der Staten-Generaal van 7 april 2010, Kamerstukken II, vergaderjaar 2009-2010, 32140, nr. 4") at 1. The report has been attached to this letter.

Netherlands government, may be considered particularly awkward as the Dutch government embraced the Study Group Tax System's conclusions conceptually in 2011.[1009]

All in all, various arguments seem available to support a further exploration of the ACE in the international tax regime. Let us proceed and further explore the ACE's merits.

5.6.3 The effects that arise when it involves an (in)direct investment through an interposed controlled subsidiary

5.6.3.1 Assessing the investment returns through interposed subsidiary 'Johnson's Dinghy Sales Subsidiary Co.'

As mentioned earlier, Johnson could very well have chosen to invest in the dinghy sales activity indirectly, i.e., through an interposed controlled subsidiary. Earlier, I referred to the subsidiary as 'Johnson's Dinghy Sales Subsidiary Co.' Economically such a difference in the legal organization chosen re the investment undertaken would not substantially alter things.

If the application of the separate entity approach would be maintained under an ACE, tax cascading, i.e., economic multiple taxation would be the consequence. Moreover, the recognition of intra-group transactions between affiliated entities would still provide an incentive for the arbitrary (inter-jurisdictional) shifting of profits between affiliated corporate bodies within the same group. The introduction of an ACE would not alter this. It would not change the recognition for tax calculation purposes of intra-group transactions which, by principle, are not governed by actual market forces. Irrespective of whether an ACE applies, tax base erosion issues would remain in existence.

5.6.3.2 Tax consolidation remedies

Tax base erosion by means of employing intra-group transactions has already been referred to in section 5.4.3 in the above. Furthermore, as argued in Chapter 4, these effects could be mitigated by treating a group of affiliated corporate entities, in our example Johnson and Johnson's Dinghy Sales Subsidiary Co., as a single taxpayer for tax calculation purposes.

This can be achieved as said through tax consolidation. Also, under the application of an ACE, the effect of adopting such an approach is that the tax cascading effect under the separate entity approach would disappear. The post-tax return to equity would not alter as a consequence of the inter-positioning of corporate entities. It would be exactly the same as in the case where Johnson invests in the dinghy distribution business directly.

The post-tax return rate would equal 5.875% regardless of whether the investment activities are undertaken (in)directly. Economic double tax relief mechanisms would become redundant as the issue of economic double taxation would not arise. In addition, the same would be true in respect of measures seeking to tackle arbitrary profit shifting by means of intra-group financing transactions. As the separate entity approach would be let go, intra-group transactions would not be recognized for corporate tax calculation purposes. Consequently, such transactions would no longer *a priori* pose tax base erosion hazards. Notably, moreover, as argued in Chapter 3, double tax relief with respect to cross-border business operations may be granted in a neutral and equitable manner under the Dutch-style juridical double tax relief mechanism: the credit for domestic tax attributable to foreign income method.[1010]

[1009] See the letter of the State Secretary for Finance to the Dutch Lower House of Parliament of April 14, 2011 ("Brief Staatssecretaris van Financiën van 14 april 2011"), No. AFP/2011/248U, particularly the appendix, the 'Tax Agenda' (*"Fiscale agenda; Naar een eenvoudiger, meer solide en fraudebestendig belastingstelsel"*).

[1010] The ACE would be assigned geographically in proportion to the geographic attribution of the firm's equity capital. Contra, Court of Justice, case C-350/11 (*Argenta Spaarbank*). Regrettably, the Court requires a pro rata allocation of the 'notional interest deduction' under the Belgium tax system at hand in the case concerned to infringe primary EU law. The Court accordingly does not seem to appreciate the underlying economic rationale of the allowance for corporate equity to provide for a tax-deduction in appreciation of the opportunity costs of equity capital (it seems that the Court considered the notional interest deduction to constitute some kind of a tax subsidy). If it did, the Court would accordingly have ruled it to be consistent to attribute the notional interest deduction geographically in

Notably, the issue of how the geographical attribution of tax base across taxing jurisdictions should occur, as said, is dealt with in isolation in Chapter 6.

5.6.4 The effects involving an indirect investment in a non-controlled participation

5.6.4.1 General remarks

This brings us to the effects in the case of an investment in the equity capital of a third party, i.e., the investment in a non-controlled participation. As said, where the additional problems triggered under the separate entity approach could be resolved relatively easily through tax consolidation where it concerns a group of affiliated entities, the opposite is true where it concerns investments in the equity capital of a third party. In respect of minority shareholding interests, tax consolidation would not be appropriate.

In the above section 5.4.4 of this chapter, the adoption of an indirect tax credit mechanism has been advocated to mitigate the tax cascading effects in an equitable and tax-neutral manner. The question now arises regarding how things would turn out in conjunction with an ACE mechanism.

Let us return to Johnson's investment activities. In the event that Johnson decides to invest in a minority shareholding, the economic double taxation effects are essentially similar to those as set forth in the previous sections 5.4.3 and 5.4.4. Absent an economic double tax relief mechanism, economic double taxation arises with respect to the underlying participation's business income to the extent that it can be attributed to the relative volume of Johnson's shareholders' interest. Tax cascading effects, in other words, arise to the extent that Johnson's participation issued equity capital to Johnson ('*pro rata parte* effect'). Hence, the double taxation varies directly proportional to the volume of the shareholders' interest. [1011] The distortive economic double taxation again comprises two components: the tax levied at the level of the participation, 'component I', [1012] and the tax levied at the level of the shareholder, 'component II'. [1013]

5.6.4.2 Mitigating tax cascading: the indirect tax exemption under an ACE

As argued, the typical economic double tax relief mechanisms, the participation exemption mechanism and the indirect tax credit mechanism prove to operate in an unfair fashion. Both reveal flaws in their design and conceptual operation. The indirect tax exemption has been advocated as an equitable and neutral alternative. Let us look into things. Also under an ACE, the indirect tax exemption would provide relief in two consecutive steps:

1. First, the pre-underlying-tax excess earnings on the shareholder's investment in the shareholders' interest – i.e., the economic rents from the respective participation without the underlying tax as imposed at the level of the participation being taken into consideration – is included in the shareholder's taxable base. [1014] This amount could be calculated by 'grossing-up' the post-underlying-tax return on the shareholder's

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proportion to the geographic allocation of the corporate taxpayer's equity capital; that is, as the Belgian system did. Instead, the Court required Belgium to allow its resident taxpayers to take the deduction into account fully, i.e., even if their worldwide taxable base had been derived from Belgian sources only partially. Regrettably, the approach taken by the Court of Justice in *Argenta* is analytically inconsistent, and hence deeply flawed.

[1011] Again, the double taxation comprises of two components. That is, the tax levied at the level of the participation, proportional to the shareholder's shareholding interest, 'component I', and the tax levied at the level of the shareholder, 'component II'. If 'P' represents the scope of the shareholders interest, whereby $0 < P \leq 1$, the formula referred to in footnote 843, this time, alters as follows. Component I corresponds with the formula component $P.t_{sub}.[(\rho_{sub} – r_{sub}) + (1_{sub} – d_{sub})]$. Component II corresponds with the formula component $t.\{(\rho – r) + (1 – d) + P.t_{sub}.[(\rho_{sub} – r_{sub}) + (1_{sub} – d_{sub})]\}$. The aggregate ('$\sum$') of components I and II, $P.t_{sub}.[(\rho_{sub} – r_{sub}) + (1_{sub} – d_{sub})] + t.\{(\rho – r) + (1 – d) + P.t_{sub}.[(\rho_{sub} – r_{sub}) + (1_{sub} – d_{sub})]\}$, accordingly, reflects the tax cascading effects in the event of an investment in a non-controlled participation.

[1012] As said, element I corresponds with the formula component $P.t_{sub}.[(\rho_{sub} – r_{sub}) + (1_{sub} – d_{sub})]$.

[1013] As said, element II corresponds with the formula component $t.\{(\rho – r) + (1 – d) + P.t_{sub}.[(\rho_{sub} – r_{sub}) + (1_{sub} – d_{sub})]\}$.

[1014] $(\rho – \alpha.r) + (1 – d)$.

equity investment by multiplying the post-tax proceeds from the respective participation with a factor of '1/(1– t)'.[1015] The tax impost is calculated accordingly;

2. Subsequently, second, a credit would become available. The credit equals the tax imposed at the level of the shareholder that is economically attributable to the net excess earnings from the participation.[1016]Accordingly, the credit granted is calculated autonomously. More specifically, the credit equals the amount of tax economically attributable to the excess earnings from the respective equity investment. Economically related expenses are identified subsequent to a functional and factual analysis.

The relief would be calculated in a manner akin to the fraction as forwarded in the above section 5.4.4.3, which for its turn has been derived analogue to the juridical double tax relief mechanism advocated in Chapter 3. Accordingly, the relief would be calculated according to the following fraction:

*(Grossed-up net economic rents from a participation / Worldwide economic rents) * Domestic tax on worldwide economic rents*

The grossed-up net economic rents from the participation are included in the taxable base with respect to which the tax impost is calculated accordingly (Step 1: 'In'). Subsequently, the tax that is economically attributable to these rents is available to be credited against the tax as calculated under the first step (Step 2: 'Out').

Also under an ACE, the indirect tax exemption would achieve economic single taxation equitably and tax neutrally. This may be illustrated by means of numerical examples. Johnson invests in 'Johnson's Participation in Distribution Co.' Under an ACE, the tax calculations at the level of 'Johnson's Participation in Distribution Co.' are identical to those at the level of Johnson in the case of a direct investment as set forth in section 5.6.2. Under the assumption that the post-tax returns as derived by 'Johnson's Participation in Distribution Co.' are immediately repatriated to Johnson, the effects recognized at the level of Johnson are as follows (fig. 57):[1017]

Fig. 57. Johnson's ACE Calculation

	Period 1	***Period 2***
Johnson's ACE Calculation		
Earnings		
Gross Earnings ('EBITDA')	0	+ 10,475[1018]
Gross-up***)**	0	– 25[1019]
Aggregate	0	+ 10,500[1020]
Costs		
Financing Expenses (interest)	0	– 240[1021]
Opportunity costs of capital	0	– 160[1022]
Depreciation	0	– 10,000[1023]
Aggregate	0	– 10,240[1024]
Tax Levy		
Aggregate (Taxable Amount)	0	+ 100[1025]

[1015] $1/(1 – t).\{(\rho – r) + (1 – d) + P.t_{sub}.[(\rho_{sub} – r_{sub}) + (1_{sub} – d_{sub})]\}$.
[1016] $t.[(\rho – r) + (1 – d)] – t.[(\rho – r) + (1 – d)]$.
[1017] Notably, dividend taxation again is assumed to be non-existent, a dividend tax exemption is considered to apply, or it is assumed that the dividend tax is fully creditable against corporate income tax.
[1018] 10,500 – 25 = 10,475. Accordingly: $1 + \rho + P.t_{part}.[(\rho_{part} – r_{part}) + (1_{part} – d_{part})]$.
[1019] – 0.25 * [(500 – 400) + (10,000 – 10,000)] = 25. Accordingly: $– P.t_{part}.[(\rho_{part} – r_{part}) + (1_{part} – d_{part})]$.
[1020] $1 + \rho$. Alternatively, $1/(1 – t).\{(\rho – r) + (1 – d) + P.t_{part}.[(\rho_{part} – r_{part}) + (1_{part} – d_{part})]\}$.
[1021] $– \alpha.r$.
[1022] $– (1 – \alpha).r$.
[1023] $– d$. For simplicity reasons, it is assumed that $d = d_{part}$.
[1024] $– r – d$.
[1025] (500 – 240 – 160) + (10,000 – 10,000) = 100. Accordingly: $(\rho – r) + (1 – d) + P.t_{part}.[(\rho_{part} –r_{part}) + (1_{part} – d_{part})] – P.t_{part}.[(\rho_{part} – r_{part}) + (1_{part} – d_{part})] = (\rho – r) + (1 – d)$. For technical reasons, alternatively, one may decide on adopting: $1/(1 – t).\{(\rho – r) + (1 – d) + P.t_{part}.[(\rho_{part} – r_{part}) + (1_{part} – d_{part})]\}$.

Tax*) (25%)	0	+ 25[1026]
'Indirect Tax Exemption'*)	0	– 25[1027]
Aggregate / Tax Payable	0	0

*) A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax creditable.

Alternatively, the tax payable can be calculated in the followings steps:

1. The tax calculated on the grossed-up net rents from the participation, which equals €100 (i.e., €75[1028] + €25[1029]) amounts to €25;[1030]
2. The double tax relief available amounts to €25;[1031]
3. The tax payable, due to the absence of other sources of income, amounts €0.

As a table (left to right – fig. 58):

Fig. 58. Tax Positions of Johnson and 'Johnson's Participation in Distribution Co' (pro rata parte)

	Economic rents	***Gross-up***	***Tax base***	***Tax****	***Relief****	***Tax payable***
Johnson	+ 75	+ 25	+ 100	+ 25	– 25	0
Johnson's Participation (pro rata parte)	+ 100	n/a	+ 100	+ 25	n/a	+ 25

*) A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax creditable.

Accordingly, Johnson's business activities produce the following business cash flows (fig. 59):

Fig. 59. Johnson's Cash Flow Statement

	Period 1	***Period 2***
Johnson's Cash Flow Statement		
Real Transactions ('R')		
Investment	– 10,000[1032]	
Gross Return on Investment		+ 10,475[1033]
Aggregate	– 10,000	+ 10,475
Financial Transactions ('F')		
Debt Issuance	+ 6,000[1034]	
Repayment Principal Amount		– 6,000[1035]
Interest Paid		– 240[1036]
Aggregate	+ 6,000	– 6,240[1037]
Tax Levy		
Tax*) Johnson (25%)	0	0[1038]
Aggregate	– 4,000[1039]	+ 4,235[1040]

*) A tax preceded by a '+' sign represents an amount of tax payable

The net outward bound cash flow in period 1 equals €4,000, an amount equal to the invested equity capital. The transactions in period 1 again do not constitute a taxable event under an ACE. As said, the ACE shares this feature with both the conventional corporate income tax and the CBIT. The net inbound cash flow in period 2 under an ACE with an indirect tax

[1026] 0,25 * [(500 – 400) + (10.000 – 10.000) – (25 + 25)] = 25. Accordingly: t.[(ρ – r) + (1 – d)].
[1027] – 0,25 * [(500 – 400) + (10.000 – 10.000) – 25 + 25] = –25. Accordingly: –t.[(ρ – α.r) + (1 – d)].
[1028] 475 – 400 = 75.
[1029] 0.25/0.75 * 75 = 25.
[1030] 0.25 * 100 = 25.
[1031] 100 / 100 * 25 = 25.
[1032] – 1.
[1033] 10,500 – 25 = 10,475. Accordingly: $1 + \rho + P.t_{part}.[(\rho_{part} – r_{part}) + (1_{part} – d_{part})]$.
[1034] α.
[1035] – α.
[1036] – α.r.
[1037] – α.(1 + r).
[1038] t.[(ρ – r) + (1 – d)] – t.[(ρ – r) + (1 – d)].
[1039] – (1 – α).
[1040] $(1 – \alpha) + (\rho – \alpha.r + P.t_{part}.[(\rho_{part} – r_{part}) + (1_{part} – d_{part})])$.

exemption equals €4,235. The net post-tax return to the invested equity capital ('v_{ACE}^{DTR}') equals €235, a percentage of 5.875. [1041] What does this tell us?

We are back to where we started in section 5.6.2 of this chapter, i.e., the section forwarding the effects under an ACE in the event of a direct investment. The tax cascading effects that occur under the separate entity approach have been resolved equitably.

5.6.4.3 Loss recapture and profit carry-forward mechanisms required

Adding two features two the system: a 'recapture of losses feature' and a 'carry-forward of profits feature'

This being said, however, to ascertain single taxation under an ACE in subsequent taxable periods, once again two additional properties need to be added. Similar to the indirect tax exemption mechanism under the conventional corporate income tax as forwarded in the above, the double tax relief mechanism needs to be attributed with a 'loss-recapture mechanism' and a 'profit-carry forward mechanism'.

Illustrating the effects: back to Johnson

The effects of adopting such additional features would be as follows. Let us assume that the imposition of corporate tax under an ACE mechanism occurs in two taxable periods, 'Taxable Period 1' and 'Taxable Period 2'. Accordingly, 'Period 2' referred to in the above tables is divided into two taxable periods. Moreover, let us assume that Johnson, in addition to the rents derived from its investment in 'Johnson's Participation in Distribution Co.', for the sake of convenience now relabeled as 'source a)', derives income from a direct investment, for the sake of convenience labeled as 'source b)'. In addition, let us consider the following three alternative scenarios:

1. The rents derived from both sources, i.e., 'Johnson's Participation in Distribution Co.', 'source a)' and the additional direct investment, 'source b)', account for positive amounts in both taxable periods;
2. The rents from 'source a)', account for negative amounts in 'Taxable Period 1' and positive amounts in 'Taxable Period 2'; the rents from the additional 'source b)', account for positive amounts in both taxable periods; to ensure single taxation, a recapture mechanism is required.
3. The rents from 'source a)' account for positive amounts in both taxable periods; the rents from the additional 'source b)' account for negative amounts in 'Taxable Period 1' and positive amounts in 'Taxable Period 2'; to ensure single taxation, a carry-forward mechanism is required.

Ad 1. The rents derived from both sources account for positive amounts in both taxable periods. Assume that the economic rents derived from the investment in source a), 'Johnson's Participation in Distribution Co.', remain unchanged and equal €75. And assume that the economic rents derived from the investment in the additional direct investment, source b), equal €500. The returns are attributed to the taxable periods in the following manner. The taxable proceeds in respect of source a) account for €30 in 'Taxable Period 1' and €45 in 'Taxable Period 2'. The underlying taxable rents of 'Johnson's Participation in Distribution Co.', i.e., to the extent that they are *pro rata parte* attributed to Johnson equity investment respectively, hereinafter labeled as 'source a)*', respectively equal €40 and €60. The taxable proceeds in respect of source b) equally tax account for €250 in both taxable periods. The tax rate remains to equal a linear 25%. Forwarded as a schedule (figs. 60, 61, 62, and 63):

Fig. 60. Given attribution taxable proceeds to taxable periods 1 and 2

Sources of	***Proceeds***	***Proceeds***	***∑***

[1041] (4,235 / 4,000) – 1 = 0.05875. Accordingly: $v_{ACE}^{DTR} = (1 – \alpha) + (\rho – \alpha.r + P.t_{part}.[(\rho_{part} – r_{part}) + (1_{part} – d_{part})]) / (1 – \alpha) – 1 = (\rho – r + P.t_{part}.[(\rho_{part} – r_{part}) + (1_{part} – d_{part})]) / (1 – \alpha) + r$.

	income	***Taxable Period 1***	***Taxable Period 2***	
Johnson	source a)	30	45	75 (double tax relief)
	source b)	250	250	500
Johnson's Participation (pro rata parte)	source a)*	40	60	100

Under these circumstances, the tax effects would be accordingly (fig. 62):

Fig. 61. Taxable Period 1; tax positions Johnson & Johnson's Participation

	a)	***a)****	***b)***	***Gross-up /1***	***∑ Tax base***	***Tax levy***	***Econ. double tax relief /2***	***Tax Payable /3***
Johnson	30	-	250	10	290	72.50	10	62.50
Johnson's Participation	-	40	-	-	40	10	-	10

/1: 0.25 / 0.75 * 30 = 10;
/2: (30 + 10) / 290 * 72.50 = 10;
/3: 72.50 – 10 = 62.50.

Fig. 62. Taxable Period 2; tax positions Johnson & Johnson's Participation

	a)	***a)****	***b)***	***Gross-up /1***	***∑ Tax base***	***Tax levy***	***Econ. double tax relief /2***	***Tax Payable /3***
Johnson	45	-	250	15	310	77.50	15	62.50
Johnson's Participation	-	60	-	-	60	15	-	15

/1: 0.25 / 0.75 * 45 = 15;
/2: (45 + 15) / 310 * 77.50 = 15;
/3: 77.50 – 15 = 62.50.

Fig. 63. Taxable Periods 1 & 2; Overall Tax Positions Johnson & Johnson's Participation

	Tax Payable Taxable Period 1	***Tax Payable Taxable Period 2***	***∑ Tax Payable***
Johnson source a), post-double tax relief	0	0	0
Johnson source b)	62.50	62.50	125
*Johnson's Participation source a)**	10	15	25

The tables illustrate that Johnson, in effect, would be liable to pay tax on the €500 rents on its direct investment, source b). Johnson would be liable to pay an amount of tax equal to €62.50 in Taxable Period 1 and €62.50 in Taxable Period 2. That is an aggregate tax payable of €125. That amount equals an overall amount of tax payable which effectively equals a rate of 25%. The (grossed-up) rents on Johnson's investment in 'Johnson's Participation in Distribution Co.', 'source a)', of €100 do not trigger a tax liability at the level of Johnson. This would be fair as Johnson's Participation in Distribution Co.', already would be liable to pay tax on the underlying rents, i.e., source a)*. These equal €100 triggering a tax payable at the level of the participation of €25, specifically €10 in Taxable Period 1 and €15 in Taxable Period 2.

Economic single taxation efficiently achieved

Accordingly, economic single taxation on the underlying rents of €100, source a)*, would be achieved. In terms of amounts of tax payable, the attribution of the proceeds to taxable periods does not entail any differences in tax treatment under the application of the indirect tax exemption mechanism. That is, in comparison with the scenario set forth in section 6.2 (effects direct investment under an ACE). Accordingly, the recognized remaining distortions, i.e., regarding investment location decisions, are not exacerbated. The amounts of tax payable remain unchanged. The preliminary conclusion that we are back to where we started

in section 6.2 remains unchanged. Accordingly, the indirect tax exemption mechanism operates equitably to this extent.

Ad 2. The rents from 'source a)', account for negative amounts in 'Taxable Period 1' and positive amounts in 'Taxable Period 2', while the rents from 'source b)' account for positive amounts in both taxable periods. Assume that the economic rents derived from the investment in source a), 'Johnson's Participation in Distribution Co.', remain unchanged and equal €75. And assume that the net economic rents derived from the investment in the additional direct investment, source b), equal €500. However, these rents are attributed to the taxable periods differently. The taxable proceeds in respect of source a) account for €30 in the negative in 'Taxable Period 1' and €105 in the positive in 'Taxable Period 2'. The underlying taxable rents of 'Johnson's Participation in Distribution Co.', i.e., to the extent that they are *pro rata parte* attributed to Johnson equity investment, 'source a)*', respectively equal €40 in the negative (loss to be compensated vertically) and €140.[1042] The taxable proceeds in respect of source b) remain unchanged and equally tax account for €250 in both taxable periods. Forwarded as a schedule (fig. 64):

Fig. 64. Given attribution taxable proceeds to taxable periods 1 and 2

	Sources of income	***Yields Taxable Period 1***	***Yields Taxable Period 2***	∑
Johnson	source a)	<30>	105	75 (double tax relief)
	source b)	250	250	500
Johnson's Participation (pro rata parte)	source a)*	<40>	140	100

To secure single taxation, a loss-recapture mechanism equivalent to the recapture mechanism for juridical double tax relief purposes, as set forth in Chapter 3, is now required. Such a recapture would need to operate accordingly (figs. 65, 66 and 67):

Fig. 65. Taxable Period 1; tax positions Johnson & Johnson's Participation

	a)	***a)****	***b)***	***Gross-up /1***	***Loss Carry forward***	***∑ Tax base***	***Tax levy***	***Double tax relief Recapture /****	***Econ. double tax relief /2***	***Tax Payable /3***	*Tax Payable /3*
Johnson	<30>	-	250	<10>	-	210	52.50	<40>	0	52.50	62.50
Johnson's Participation	-	<40>	-	-	<40>	0	0	-	-	0	25

/1: 0.25 / 0.75 * <30> = <10>;
/2: n/a; 0
/3: 0,25 * 210 = 52.50.
/*: Administrative notice: double tax relief recapture next year

Fig. 66. Taxable Period 2; tax positions Johnson & Johnson's Participation

	a)	***a)****	***b)***	***Gross-up /1***	***Loss Carry forward***	***∑ Tax base***	***Tax levy***	***Double tax relief Recapture *)***	***Econ. double tax relief /2***	***Tax Payable /3***	*Tax Payable /3*
Johnson	105	-	250	35	-	390	97.50	40	25	72.50	62.50
Johnson's participation	-	140	-	-	40	100	25	-	-	25	25

/1: 0.25 / 0.75 * 105 = 35;
/2: (105 + 35 – 40/*) / 390 * 97.50.50 = 25;
/3: 97.50 – 25 = 72.50;
/*: recapture reduces numerator double tax relief fraction

[1042] See, notably, Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, at 47. The authors argue that the loss carry-forward should carry interest. This matter is not dealt with in the numerical examples for simplicity reasons.

Fig.67. Taxable periods 1 & 2; overall tax positions Johnson & Johnson's participation

	Tax Payable Taxable Period 1	***Tax Payable Taxable Period 2***	***∑ Tax Payable***
Johnson source a), post-double tax relief	0	0	0
Johnson source b)	52.50	72.50	125
Johnson's Participation source a)*	0	25	25

The tables illustrate that Johnson, in effect, would be liable to pay tax on the €500 rents on its direct investment, source b). Johnson would be liable to pay an amount of tax equal to €52.50 in Taxable Period 1 and €72.50 in Taxable Period 2. That is an aggregate tax payable of €125. That equals an overall amount of tax payable at a rate of 25%. The (grossed-up) rents on Johnson's investment in 'Johnson's Participation in Distribution Co.', 'source a)', of €100 do not trigger a tax liability at the level of Johnson. This is fair as Johnson's Participation in Distribution Co.', already would be liable to pay tax on the underlying rents, i.e., source a)*. These equal €1,000, leaving a tax payable at the level of the participation of €25, specifically €0 in Taxable Period 1 due to the tax loss suffered, and €25 in Taxable Period 2.

Economic single taxation efficiently achieved

Accordingly, due to the recapture mechanism, economic single taxation of the underlying economic rents of €100, source a)*, would be achieved. The loss suffered is recognized for tax calculation purposes in Taxable Period 1.

This is fair. The loss has been suffered at that time. No liquidity disadvantage arises if put in comparison with a typical participation (base) exemption mechanism. The Taxable Period 1 loss is recaptured in Taxable period 2 for economic double tax relief calculation purposes to ensure that the loss is not taken into account twice (which would entail economic non-taxation).

Technically, the recapture in Taxable Period 2 takes place by reducing the numerator in the double tax relief mechanism's fraction with an amount equal to the loss suffered in Taxable Period 1. Conceptually, the recapture would operate in a manner akin to the recapture in the juridical double tax relief mechanism advocated in Chapter 3, section 4.2.2. [1043]

In summary, in terms of nominal amounts of tax payable, the attribution of the proceeds to taxable periods does not entail any differences in tax treatment under the application of the indirect tax exemption mechanism. That is, in comparison with the scenario set forth in section 5.6.2 in terms of amounts of taxes payable (effects direct investment under an ACE). Accordingly, the remaining recognized distortions, i.e., regarding investment location decisions, are not exacerbated. The preliminary conclusion that we are back to where we started in section 5.6.2 remains unchanged. Accordingly, the indirect tax exemption mechanism, also to this extent, operates equitably.

Ad 3. The rents from 'source a)' account for amounts in the positive in both taxable periods; the rents from the additional 'source b)' tax account for amounts in the negative in 'Taxable Period 1' and for amounts in the positive in 'Taxable Period 2'. Assume that the economic rents derived from the investment in source a), 'Johnson's Participation in Distribution Co', remain unchanged and again equal €75. And assume that the economic rents derived from the investment in the additional direct investment, source b), equal €500. However, again the

[1043] A liquidation losses set-off regime allowing the corporate taxpayer involved to tax-deduct final losses realized upon the liquidation of a (foreign) corporate body in which the taxpayer holds a shareholding interest, such as the one adopted by the Netherlands (laid down in Article 13d Dutch CITA, would become redundant. The same holds true for a type of 'add-back-regulation' such as the one adopted by the Netherlands (laid down in Article 13aa-6 Dutch CITA. Such an amendment would enhance fairness relative to these measures as they entail liquidity disadvantages for merely enabling the setting-off of a tax loss at a moment later in time than actually suffered.

returns are attributed to the taxable periods differently. Assume that, like the scenario ad. 1, the taxable rents in respect of source a) remain unchanged this time and account for €30 in 'Taxable Period 1' and €45 in 'Taxable Period 2'. The underlying taxable rents of 'Johnson's Participation in Distribution Co.', i.e., to the extent that they are *pro rata parte* attributed to Johnson equity investment, 'source a)*', respectively equal €40 and €60. This time, the taxable proceeds in respect of source b) alter. The rents from source b) tax account for €150 in the negative in 'Taxable Period 1' (loss to be compensated vertically) and €650 in the positive in 'Taxable Period 2'. Forwarded as a schedule (fig. 68):

Fig. 68. Given attribution taxable proceeds to taxable periods 1 and 2

	Sources of income	***Yields Taxable Period 1***	***Yields Taxable Period 2***	∑
Johnson	source a)	30	45	75 (double tax relief)
	source b)	<150>	650	500
Johnson's Participation (pro rata parte)	source a)*	40	60	100

To secure single taxation, now a profit carry-forward mechanism, equivalent to the carry-forward mechanism for juridical double tax relief purposes as set forth in Chapter 3, is required. Such a carry-forward would need to operate accordingly (figs. 69, 70, and 71):

Fig. 69. Taxable Period 1; tax positions Johnson & Johnson's participation

	a)	***a)****	***b)***	***Gross-up /1***	***Loss Carry forward***	***∑ Tax base***	***Tax levy***	***Double tax relief carry forward /****	***Econ. double tax relief /2***	***Tax Payable /3***	Tax Payable /3
Johnson	30	-	<150>	10	<110>	0	0	40	0	0	62.50
Johnson's Participation	-	40	-	-	-	40	10	-	-	10	25

/1: 0.25 / 0.75 * 30 = 10;
/2: n/a; 0
/3: n/a; 0 / 0,25 * 40 = 10 (Johnson's participation);
/*: Administrative notice: double tax relief carry forward to next year

Fig. 70. Taxable Period 2; tax positions Johnson & Johnson's participation

	a)	***a)****	***b)***	***Gross-up /1***	***Loss Carry forward***	***∑ Tax base***	***Tax levy***	***Double tax relief Carry forward *)***	***Econ. double tax relief /2***	***Tax Payable /3***	Tax Payable /3
Johnson	45	-	650	15	<110>	600	150	<40>	25	125	62.50
Johnson's Participation	-	60	-	-	-	60	15	-	-	15	25

/1: 0.25 / 0.75 * 45 = 15;
/2: (45 + 15 + 40/*) / 600 * 150 = 25;
/3: 150 – 25 = 125;
/*: carry forward increases numerator double tax relief fraction

Fig. 71. Taxable Periods 1 & 2; overall tax positions Johnson & Johnson's participation

	Tax Payable Taxable Period 1	***Tax Payable Taxable Period 2***	***∑ Tax Payable***
Johnson source a), post-double tax relief	0	0	0
Johnson source b)	0	125	125
*Johnson's Participation source a)**	10	15	25

The tables illustrate that Johnson, in effect, would be liable to pay tax on the €500 rents derived from its direct investment, source b). Johnson would be liable to pay an amount of tax

equal to €0 in Taxable Period 1 due to the taxable loss suffered and €125 in Taxable Period 2. That is an aggregate tax payable of €125. That equals an overall tax payable effectively imposed at a 25% rate. The (grossed-up) rents derived from Johnson's investment in 'Johnson's Participation in Distribution Co.', 'source a)', of €100 do not initiate a tax liability at the level of Johnson. This is fair as Johnson's Participation in Distribution Co', already would be liable to pay tax on the underlying economic rents, i.e., source a)*. These equal €100 triggering a tax payable at the level of the participation of €25, specifically €10 in Taxable Period 1 and €15 in Taxable Period 2.

Economic single taxation efficiently achieved

Accordingly, due to the profit carry-forward mechanism, economic single taxation of the underlying rents of €100, source a)* would be achieved. The loss suffered from source b) is recognized for tax calculation purposes in Taxable Period 1 and set-off against the taxable income from source a) leaving a nil amount of tax payable. However, as the ACE would not provide for a tax refund, a latent double tax relief entitlement with respect to the proceeds from source a) in Taxable period 1 arises. To ensure that this relief entitlement is appreciated, the application of the carry-forward mechanism entails that the source a) rents realized in Taxable Period 1 do not diminish for economic double tax relief purposes but instead are taken into account as rents eligible for relief in Taxable Period 2.

Consequently, relief comes available in Taxable Period 2 guaranteeing economic single taxation. Technically, the carry-forward in Taxable Period 2 takes place by increasing the numerator in the double tax relief mechanism's fraction with an amount equal to the carried forward rents from source a) to the extent that no relief is granted in Taxable Period 1. Conceptually, the carry-forward operates in a manner akin to the carry-forward feature in the juridical double tax relief mechanism advocated in Chapter 3, section 4.2.3.[1044]

In summary, in terms of nominal amounts of tax payable, the attribution of the rents to taxable periods does not entail any differences in tax treatment under the application of the indirect tax exemption mechanism. That is, in comparison with the scenario set forth in section 5.6.2 in terms of nominal amounts of tax payable (effects direct investment under an ACE). Accordingly, the remaining distortions in the investment location decisions are not exacerbated. The preliminary conclusion that we are back to where we started in section 6.2 remains unchanged. Accordingly, the indirect tax exemption mechanism, also to this extent, would operate equitably.

5.7 Effects under Cash Flow Taxes

5.7.1 General

5.7.1.1 Inbound and outbound cash flows are taxable events

Despite the ACE's fairness enhancing characteristics of imposing equal to statutory AETRs, *de facto* resolving the financing discrimination issue while producing nil METRs, economists have explored other alternative tax bases as well.[1045] For this purpose, reference is made to the so-called cash flow taxes ('CFTs'). To my knowledge tax lawyers are relatively unfamiliar with the properties of CFTs. Let us therefore follow the economists' footprints and look into these alternative taxes' merits also.

Cash flow taxes, CFTs, basically are tax imposts which consider all corporate cash flows as taxable events for tax calculation purposes, rather than the returns on corporate

[1044] A tax credit carry forward mechanism, such as the one adopted by the Netherlands (laid down in Article 23c-7 Dutch CITA, would become redundant.
[1045] Cash Flow Taxes have been advocated already in the 1970s. See the Institute for Fiscal Studies. Their findings are sometimes referred to as the 'Meade Committee Study'. See The Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation* (1978).

investments.[1046] Both inbound payments and outbound payments constitute a taxable event. CFTs share this property with European Union value added taxation. That is, with the (administrative) exception that European Union value added taxation recognizes the submission of an invoice as the taxable event rather than the actual payment in return for goods provided and services rendered.

5.7.1.2 Cash flow taxes in three variations

On the drawing board cash flow taxes are typically recognized to exist in three variations:

1. The 'Real Transactions Based Cash Flow Tax' ('R-CFT'), which recognizes as a taxable event all cash flows related to goods provided and services rendered, with the exception of cash flows related to financial transactions, i.e., debt financing arrangements;[1047]
2. The 'Real and Financial Transactions Based Cash Flow Tax' ('R+F-CFT'), which recognizes as a taxable event all cash flows related to goods provided and services rendered, i.e., including cash flows related to financial (i.e., debt financing) transactions;
3. The 'Share Based Cash Flow Tax' ('S-CFT'), which recognizes as a taxable event all cash flows related to share transactions, i.e., equity financing arrangements. [1048]

Common to all CFTs is the property that outbound cash flows trigger tax refunds, while inbound cash flows trigger liabilities to pay tax. Note that, in addition, cash raised from new equity issues would be excluded from the receipts.[1049] CFTs share this property with European Union value added taxation, which also allows for tax refunds.

Moreover, worth noting is that, actually, there are no real conceptual differences to be recognized between an R+F-CFT and the S-CFT.[1050] This may be appreciated if one

[1046] Contrary to the earlier discussed alternatives (i.e., the corporate income tax, CBIT, ACE), the timing of payments constitutes the taxable moment rather than the moment of realization. However, deferral issues would not occur as all cash flows, both inward bound and outward bound cash flows trigger tax consequences. The first mentioned would trigger a tax payable, the second mentioned a tax refund. Accordingly, it would for instance be of no use to delay payments as that would not only delay the tax liability but also the tax refund at the level of the business partner with whom the business transaction has been arranged. Similar effects may be recognized under European Union value added taxation where tax deferral issues generally are absent as well.

[1047] The proposals of Hall and Rabushka for a 'flat tax' recognize the R-CFT as the most suited candidate for a business income tax. See Robert E. Hall et al, *The Flat Tax 2nd edition* (1995). Also Bradford favors an R-CFT, which in a cross-border context should apply on a destination basis (as is also currently the case under European Union value added tax). Bradford's ideas on an 'X-tax' can, amongst others, be found in David F. Bradford, 'Blueprint for International Tax Reform', 26 *Brooklyn Journal of International Law* 1449 (2000-2001), at 1449-1463, David F. Bradford, 'Transition to and Tax Rate Flexibility in a Cash-Flow Type Tax', 12 *Tax Policy and the Economy* 151, at 151–172, David F. Bradford, 'Addressing the Transfer-Pricing Problem in an Origin-Basis X Tax', 10 *International Tax and Public Finance* 591 (2003), at 591-610, David F. Bradford, *The X Tax in the World Economy* (2004). Bradford's X-Tax has, for instance, been discussed by Weisbach, David A. Weisbach, 'Does the X-Tax Mark the Spot?', 56 *SMU Law Review* 201 (2003), at 201–238 and Cnossen, Sijbren Cnossen, 'Evaluating the National Retail Sales Tax from a VAT Perspective', in George R. Zudrow et al, *United States Tax Reform in the 21st Century* (2002) 215, at 215-244.

[1048] In addition, various VAT-style business income taxes have been advocated. All conceptually relate to the CFTs discussed in this study. See, for instance, the 'Business Value Tax' ('BVT') proposed by Bird and Mintz. See also Richard M. Bird et al, 'Tax Assignment in Canada: A Modest Proposal', in Harvey Lazar et al, *The State of Federation 1999/2000* (2001) 262, at 262-292. Another example is the 'subtraction-method VAT' ('S-VAT'), which was part of the 'Unlimited Savings Allowance Tax' ('USA Tax'), advocated, e.g., by Seidman, in Laurence S. Seidman, *The USA Tax: A progressive Consumption Tax* (1997). These taxes are not further discussed. For a discussion of the USA Tax see Reuven S. Avi-Yonah, 'From Income To Consumption Tax: International Implications', 33 *San Diego Law Review* 1329 (1996), at 1329 – 1354. Moreover, the so-called Norwegian-style Dual Income Tax ('DIT') is left untouched also. See on the DIT, Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, at 51-54.

[1049] See Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), at 9.

[1050] See for instance Stephen R. Bond et al, 'Generalised R-based and S-based taxes under uncertainty', 87 *Journal of Public Economics* 1291 (2003), at 1291 – 1311, who demonstrate the equivalence of the S-CFT and R+F-CFT. See also Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448. An exception worth mentioning is that an S-CFT produces zero taxes on retentions. This could render the S-CFT vulnerable to tax avoidance strategies. See Geerten M. Michielse, 'EU

recognizes that the net inflow of real transactions and financial transactions, by accounting identification, necessarily needs to equal to the net outflow of share transactions (i.e., R + F = S). Accordingly, it is fair to say that there are two rather than three conceptually distinct CFT variations, i.e., the R-CFT on the one hand and the R+F-CFT / S-CFT on the other. To my knowledge, CFTs particularly exist on the drawing board. There is little to no real life experience with them.[1051]

5.7.2 Effects under Real Transactions Based Cash Flow Tax

5.7.2.1 General remarks

Let us commence with the 'Real Transactions Based Cash Flow Tax'.[1052] As said, the R-CFT recognizes as a taxable event all cash flows related to goods provided and services rendered, with the exception of cash flows related to financial transactions. *Real* transactions, for instance, comprise of sales (inflows), wages and (fixed) asset acquisitions (outflows). *Financial* transactions for instance comprise of borrowings (inflows), principal amount repayments and interest expenses (outflows). The outward bound cash flows related to real transactions trigger tax refunds. The inward bound cash flows related to real transactions trigger liabilities to pay tax.

Accordingly, the R-CFT's taxable base is conceptually similar to European Union value added taxation, which typically exempts financial transactions from the imposition of value added tax as well. At least, this holds true with the exception that R-CFT recognizes wage payments for tax calculation purposes while European Union value added taxation does not. Worth noting is that simultaneously, the R-CFT share the administrative need in European Union value added taxation to distinguish between real and financial transactions. That is, an administrative requirement is not necessarily easy to establish (triggering complexities, for instance, in cases of financial lease arrangements). Moreover, financial institutions would be exempt from tax under an R-CFT. That would trigger the need to adopt a specific income tax for financial institutions. [1053] These issues are absent under the R+F-CFT discussed hereunder.[1054]

In terms of nominal amounts of tax payable, the R-CFT corresponds with the CBIT, which exempts (proceeds from) debt financing from the taxable base. Accordingly, the taxable base under an R-CFT in terms of nominal amounts of tax payable is broader than under, for instance, the conventional corporate income tax.

However, in terms of effective tax burdens imposed, there is a vast difference to be recognized between the R-CFT on the one hand and the ACE, CBIT and conventional corporate income tax on the other, as the first mentioned entails a tax refund to the taxpayer upon the outbound payment, i.e., the investment in period 1 and a tax payable upon the investment's return in period 2, while the latter do not enable tax refunds at the time of the investment in period 1 and merely recognizes a taxable event at the time the respective investment yields a taxable return in period 2. Accordingly, contrary to the ACE, CBIT and

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Harmonization – an Obstacle for new initiatives in drafting corporate income tax systems', *National Tax Association*, 95th Annual Conference on Taxation (2003): 236-240.

[1051] See Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, at 1-60. Notably, Estonia makes use of a tax upon profit distributions that is akin to a S-CFT. Further, the Caribbean part of the country of The Netherlands within the Kingdom of The Netherlands, i.e., the islands of Bonaire, Saint Eustace and Saba utilize a similar profit distribution tax as well.

[1052] For some further discussion, see Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008).

[1053] This is not further discussed.

[1054] This has lead for instance Mclure and Zodrow to argue not to distinguish between real and financial transactions and to include both in the taxable base. See Charles E. McLure, Jr., et al, 'A Hybrid Approach to the Direct Taxation of Consumption', in Michael J. Boskin, *Frontiers of Tax Reform* (1996) 70. See also Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010. Auerbach favors a destination based R+F-CFT also. As both real and financial transactions are taken into account it may be applied to both financial and non-financial institutions.

conventional corporate income tax, interest yielding funds become available upon the investment. However, if that property would be cancelled out, the R-CFT would turn out to operate conceptually in a manner surprisingly akin to an ACE. Let us proceed with the analysis.

5.7.2.2 The effects involving a direct investment

Assessing the investment returns of 'Ben Johnson Dinghy Selling Company'

Let us return to our taxpayer Johnson and its dinghy business activities to illustrate the effects of an R-CFT. As said, Johnson directly invests in a dinghy sales activity. Let us suppose that the tax rate equals a linear 25% (again, progressivity is not considered merely for the sake of simplicity). Under an R-CFT, the effects are as follows (fig. 72):

Fig. 72. Johnson's R-CFT calculation

	Period 1	***Period 2***
Johnson's R-CFT calculation		
Earnings		
Gross Return on Investment	0	+ 10,500[1055]
Aggregate	0	+ 10,500
Costs		
Investment	– 10,000[1056]	0
Aggregate	– 10,000	+ 10,500
Tax Levy		
Aggregate (Taxable Amount)	– 10,000	+ 10,500
Tax*) (25%)	– 2,500[1057]	+ 2,625[1058]

*) A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax refundable.

Johnson's business activities produce the following business cash flows (fig. 73):

Fig. 73. Johnson's Cash Flow Statement

	Period 1	***Period 2***
Johnson's Cash Flow Statement		
Real Transactions ('R')		
Investment	– 10,000[1059]	
Gross Return on Investment		+ 10,500[1060]
Aggregate	– 10,000	+ 10,500
Financial Transactions ('F')		
Debt Issuance	+ 6,000[1061]	
Repayment Principal Amount		– 6,000[1062]
Interest Paid		– 240[1063]
Aggregate	+ 6,000	– 6,240[1064]
Tax Levy		
Tax*) (25%)	– 2,500[1065]	+ 2,625[1066]
Aggregate	– 1,500[1067]	+ 1,635[1068]

[1055] 1 + ρ.
[1056] – 1
[1057] 0,25 * 10,000. Accordingly: – t.
[1058] 0.25 * 10,500. Accordingly: t.(1 + ρ).
[1059] – 1.
[1060] 1 + ρ.
[1061] α.
[1062] – α.
[1063] – α.r.
[1064] – α.(1 + r).
[1065] – t.
[1066] t.(1 + ρ).
[1067] – (1 – α – t). See also Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448.
[1068] (1 – α) + (ρ – α.r) – t.(1 + ρ). See also Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 De Economist 417 (2007), at 417-448.

*) A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax refundable.

The net outbound cash flow in period 1 alters in comparison with the no-tax environment and in comparison with the aforementioned tax systems (conventional corporate income tax, CBIT and ACE). The investment transaction in period 1 constitutes a taxable event triggering a tax refund. Consequently, the outbound cash flow in period 1 equals €1,500 rather than €4,000. The net inbound cash flow in period 2 also alters. This time, the inflow in period 2 equals €1,635. The post-tax return to the invested equity capital ('$v_{R\text{-}CFT}$') equals €135, a percentage of 9.00.[1069] These numbers again tell us three things (see sections 5.7.2.3, 5.7.2.4, and 5.7.2.5).

5.7.2.3 Average Effective Tax Rates are nil; Property comes with a Price

What would be the AETR?

First, it tells us something about the AETR under an R-CFT. The application of an R-CFT produces a tax payable of €125. However, the question arises as to the extent that Johnson effectively bears the tax. Please let me elaborate on this.

A closer look reveals that one may ask whether the R-CFT actually requires Johnson to bear a tax impost. It rather seems that the fisc (tax authorities) engages in a private investment as a silent partner in Johnson's distribution activities yielding a return of €125 (i.e., 2,625 – 2,500).[1070] The amount of €125 tax payable effectively breaks down in two components: a component corresponding to the financing costs relating to the fisc's capital investment (€100 financing costs) and a component corresponding with an amount payable relating to the fisc's excess earnings (€25). How should we qualify these amounts? As a *de facto* profit tax burden? Or as the fisc's share of the excess earnings produced relating to their investment as a silent partner in Johnson's business? In period 1, Johnson's investment entails a refund from the tax authorities at an amount of €2,500.

This can be interpreted as a private investment undertaken by the government. Viz., the fisc makes these funds available to Johnson, without having any *a priori* certainty of yielding a return. Taking the debt issuance into account as well, Johnson's actual equity investment accordingly accounts for a mere €1,500 rather than the nominal amount of €4,000 which we have seen earlier. That amount of €1,500 would equal the amount of Johnson's actual equity at risk. From the perspective of the fisc, its investment of €2,500 turns out to produce a return of €125, a return rate of 5%.[1071] This holds true, despite the fact that the investment produces a return at a 6.5% rate absent a tax impost. Apparently, the silent partner settles for 5%. A deposit on a savings account at the normal market rate of 4% would yield the €2,500 investment to return €100. Hence, an amount of €100 corresponds with the normal market rate return on the fisc's capital investment. From Johnson's perspective, this amount of €100 equals the costs of capital made available by its silent partner, the tax authorities.

Consequently, the excess of €25 (i.e., 125 – 100) can be understood as the fisc's 'excess earnings' (i.e., a 1% excess return[1072]) on its €2,500 investment in Johnson's business. Perhaps, that latter amount, i.e., from Johnson's perspective, may be understood to equal the tax burden imposed on the economic rents of, in this case, €100 on the investment in the dinghy distribution business. That amount of €100 economic rents can be understood as follows. The investment of €10,000 in the dinghy selling activities produces a gross return of €500. The interests paid on the bank loan of €6,000 equal €240, the costs of capital relating

[1069] (1.635 / 1.500) – 1 = 0,09. Accordingly: $v_{R\text{-}CFT} = (1 – \alpha) + (\rho – \alpha.r) – t.(1 + \rho) / (1 – \alpha – t) – 1 = (1 – t).(\rho – r) / (1 – \alpha – t) + r$. See also Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448.
[1070] See also Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010. Auerbach recognizes this effect under its destination based R+F-CFT proposal, yet does not seem to have a problem with this.
[1071] (2,625 / 2,500) – 1 = 0.05.
[1072] 25 / 2,500 * 100 = 1%.

to the fisc's investment of €2,500 equal €100, the opportunity costs of capital relating to Johnson's equity investment of €1,500 equal €60.[1073] Consequently, the aggregate amount of €100 (i.e., 500 – 240 – 100 – 60 = 100) equals the excess earnings triggering the amount of what may *de facto* be understood as a tax burden of €25.[1074]

However, alternatively, the amount of €25 tax payable to the tax authorities (in excess of the €100) may also be considered to equal the fisc's share of excess earnings as silent partner in Johnson's dinghy distribution business. If one were to consider this latter amount of €25 to constitute the fisc's/silent partner's share of excess earnings, this qualification would render the R-CFT not to be borne by Johnson at all. Namely, Johnson's pre-tax excess earnings would then equal its post-tax excess earnings. In such a case, the amount of Johnson's pre-tax economic rents would be calculated as €75. That amount can be understood as follows. The investment of €10,000 in the dinghy selling activities produces a gross return of €500. The interests paid on the bank loan of €6,000 equal €240. The costs of capital relating to the fisc's investment of €2,500 equal €100. The opportunity costs of capital relating to Johnson's equity investment of €1,500 equal €60. In addition, the fisc's excess earnings relating to its capital investment as a silent partner equals €25. Consequently, the aggregate amount of €75 (i.e., 500 – 240 – 100 – 60 – 25 = 75) would constitute Johnson's pre-tax excess earnings taking the silent partner's share into account. The pre-tax excess earnings would then equal Johnson's post-tax excess earnings of €75 (i.e., 500 – 240 – 100 – 60 – 25 = 75). That would accordingly render the R-CFT not to be borne by Johnson! In my view, this would be the proper observation.

Notably, the expensing feature is what distinguishes the R-CFT from, for instance, the CBIT, which in this case would produce an overall amount of €125 tax payable as borne by Johnson. Contrary to the R-CFT, that amount would not break down into components since the CBIT lacks the expensing feature. Under a CBIT (or conventional corporate income tax and ACE for that matter) government would not operate as a silent partner. It would merely sit back and wait until Johnson yields a return to subsequently tax it. The question may even arise as to which extent an R-CFT actually still may be considered to constitute a tax. This question is left unanswered in this thesis.

Let us proceed to calculate AETRs. As said, AETRs are calculated by dividing the tax payable (numerator) by the pre-tax income (denominator).[1075] The question now arises of which numbers need to be put into the fraction.[1076] As we have seen in the above paragraph, in respect of the amount to be adopted in the *numerator* a decision out of three options needs to be made. The available numbers are €125, €25 and nil. Things depend on whether and to which extent the tax authorities' position, as silent partner in Johnson's investment in the dinghy distribution business, should be recognized for AETR calculation purposes. With respect to the amount to be adopted in the *denominator*, various figures are potentially available as well.

In this respect the remarks referred to in the above should be both repeated and supplemented. As discussed, in a no-tax environment, the net return on the investment in the dinghy distribution business equals €260. Taking the application of the R-CFT into account, this amount comprises of two components, both of which subsequently can be subdivided into two subcomponents (entailing an aggregate of four subcomponents). The first component amounts to €160. It refers to the 4% normal market return rate on the €4,000 equity investment. Contrary to previously discussed alternative tax bases, this amount of €160 may be considered to subsequently break down into two subcomponents. The first equals an amount of €100 corresponding to the fisc's normal market rate return on its €2,500 investment as silent partner. The second subcomponent equals an amount of €60 corresponding to

[1073] 0.04 * 1,500 = 60.
[1074] 0.25 * 100 = 25.
[1075] See Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 73.
[1076] See for a comparison Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, who refer to concerns as to whether it is suitable to find a proper measure of profit to uses as the denominator.

Johnson's normal market rate return on its €1,500 equity investment, i.e., the opportunity costs of capital. The second component amounts to €100. It refers to the remuneration for the production factor of enterprise, the excess earnings that is. Contrary to earlier discussed alternative tax bases, this amount of €100 may be considered to subsequently break up into two components as well. Viz., an amount of €25 corresponding to the fisc's share of the excess earnings in return to its €2,500 investment as silent partner (i.e., the 1% return in excess of the 4% normal market rate return) and the remaining amount of €75 corresponding to Johnson's share of the excess earnings in return to its equity investment of €1,500 (i.e., the 5% return in excess of the 4% normal market rate return[1077]). As said, the question arises as to which of these numbers should be taken into consideration? What are the numbers to pick?

The numbers to pick, in my view, are nil (numerator) and *€75* (denominator). This produces a nil AETR.[1078] Why is that? The amount of nil in the numerator can be appreciated where it is recognized that the fisc actually invests as a silent partner in Johnson's business. This effect has been caused by the R-CFT's expensing feature. The amount of €75 in the denominator can be appreciated where one recognizes that pre-tax business cash flow, i.e., the earnings exceeding the normal market rate of return, should be taken into consideration as a denominator for AETR calculation purposes. That is because all financing costs are actual costs, the opportunity costs of capital included. The fact that the pre-tax business cash flow accounts for €75 rather than €100 – which is the case under the tax bases already discussed in the above – can be appreciated should one recognize the fisc's performance as silent partner. The R-CFT's expensing feature causes the fisc to operate as a silent partner in the dinghy distribution business, yielding both a normal market rate return (€40) as well as excess earnings (€25). This observation renders Johnson's pre-tax excess earnings to equal its post-tax excess earnings, i.e., €75. Moreover, as the fisc settles for a 5% return rate, the R-CFT enables Johnson to derive a net return on its equity investment equal to 9%.

'Tax depreciation should correspond with economic depreciation issues' do not emerge

This being said, moreover, contrary to some of its counterparts discussed in the above, i.e., the conventional corporate income tax and the CBIT, no 'tax depreciation should correspond with economic depreciation issues' emerge.[1079] Due to the expensing feature the R-CFT shares with European Union value added taxation, i.e., Johnson's investment triggers a tax refund in period 1, tax depreciation is non-existent and hence, by its nature, cannot trigger this issue as present under the earlier discussed alternatives.

Notably, this does not necessarily entail that R-CFTs would resolve issues on the question as to where, i.e., in which state, the tax should be paid. Investment location distortions may still occur as a result of mutual tax rate divergences to the extent that the taxable base, as is currently the case in international taxation, is attributed to taxing jurisdictions by means of origin based profit allocation factors. The adoption of an 'origin based' R-CFT would not change this. The effects in terms of investment location decisions are difficult to predict, though. Relatively higher rates employed would entail relatively higher tax refunds. The opposite would hold under relatively lower rates. It is uncertain what the outcome would be. In addition, it is also uncertain whether the R-CFT to that extent would be able to put an end to the current 'race to the bottom' referred to in the above.

Nevertheless, this being said, the introduction of a tax rate increase in our example of Johnson investing in a dinghy distribution business – let us for instance increase the rate from 25% to, say, 30% – would entail the post-tax return to the invested equity capital ('$v_{R\text{-}CFT}$') to drop to €110 (instead of €135).[1080] Yet, that would effectively entail a post-tax return rate of

[1077] 75 / 1,500 * 100 = 5%.
[1078] 0 / 75 = 0.
[1079] See, for comparison, Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010. Auerbach argues to introduce the expensing feature under its destination based S-CFT proposal as it produces nil AETRs.
[1080] 1,110 – 1,000 = 110.

11.00% (instead of 9.00%).[1081] Remarkably, a closer look reveals that a tax rate increase would actually drive post-tax earnings upwards. That might trigger a 'race to the top' to the extent that the R-CFT would be adopted to apply on an origin basis. As said, the attribution of taxable base to taxing jurisdictions is further discussed in isolation in Chapter 6.

Absence of tax depreciation issues comes with a price; society engages in taking on private investment risks

However, the absence of issues involving tax depreciation under an R-CFT comes with a price. Such a price is absent under the alternative tax bases discussed in the above (corporate income tax, CBIT, ACE).

As said, the expensing feature under an R-CFT entails that society, as represented by the government, would engage in private investment undertakings as a silent partner in all private investments undertaken by taxpayers. In our example, the government's stake in Johnson's investment equals €2,500. Thereby, Johnson's private investor's risks are partly transferred to society.

Accordingly, under an R-CFT, government revenue would be exposed to the exact same investment risks as those faced by private investors.[1082] That would accordingly render the provision of public goods, as financed by tax revenues, to be subject to these risks as well. This role of government as a silent partner may be considered an inherent limitation of the R-CFT, as many would agree that the financing of public goods should not be put at private investors' risks. Governments should impose tax, rather than act as silent partners in business ventures. Perhaps this explains why R-CFTs have never left the drawing board. Note that the ACE lacks this feature as recognized under an R-CFT. Under an ACE, government would not be subject to these private investor's risks. Government would just sit back and tax economic rents.

Hence, it is fair to say that something needs to be done about the expensing feature in an R-CFT. However, before getting to potential solutions for this issue, some additional remarks should be made.

5.7.2.4 Financing Discrimination Issues prove not to be Resolved

Debt financing still tax-subsidized relative to equity financing

Second, the numbers forwarded in the cash flow statement above tells us something about the effects of financing decisions under an R-CFT. The cash flow calculations demonstrate that Johnson's post-tax return rate under an R-CFT ('$v_{R\text{-}CFT}$' = 9.00%) exceeds the return rate in a no tax environment (v = 6.5%) with 250 base points. Why is that?

Things can be explained by referring to the R-CFT's property that it subsidizes debt financing relative to equity financing in cases where investments yield economic rents.[1083] Had Johnson financed the dinghy sales activity entirely with equity,[1084] the R-CFT would have produced the same nominal overall amount of €125 tax payable, i.e., the aggregate of the tax refund of €2,500 in period 1 and the tax payable of €2,625 in period 2. The fisc settles consistently for a 5% return on its investment as silent partner, regardless of the manner in which the investment has been financed. Johnson's return to the invested equity of €7,500, in that case, would equal €375, i.e., a return to equity rate of 5%.[1085] That would match the return to equity

[1081] (1,110 / 1,000) – 1 = 0.11. Notably, a tax rate of 35% would entail a post-tax return rate of 17.00%: (585 / 500) – 1 = 0.1700.
[1082] See also Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448.
[1083] Zee demonstrates this effect by means of the following formula: $v_{R\text{-}CFT} – v = t \cdot \alpha \cdot (\rho – r) / [(1 – \alpha – t) \cdot (1 – \alpha)] > 0$ as $\rho > r$. See also Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448.
[1084] 1 – α = 1 (α = 0).
[1085] 7,875 / 7,500 – 1 = 0.05.

rate in a no tax environment (provided that Johnson had financed its investment entirely with equity).[1086]

Accordingly, as Johnson derives excess earnings from its dinghy selling activities, the adoption of an R-CFT would enable him to push on the return to the invested equity capital by financing its investment in the dinghy sales activity with a higher percentage of debt capital. The return to equity rate would increase even at a higher pace than the increase in return to equity rates would have been in a no tax environment. This increased leverage effect is caused by the fact that the denial of interest deductibility under an R-CFT does not fully offset the benefit of the expensing feature where the respective investment yields a return exceeding the costs of debt financing ('ρ > r').

Hence, the R-CFT proves to subsidize debt financing relative to equity financing. It would encourage taxpayers to finance their investments with as much debt as possible. The R-CFT shares this undesirable leverage property with the conventional corporate income tax discussed above. In my view, as this entails non-neutrality in financing decisions, this financing discrimination provides an inequitable feature of an R-CFT, which is in need of a resolution. It appears that again something needs to be done about the expensing feature. But before getting to potential solutions, some further remarks on the R-CFT's properties should be made.

5.7.2.5 Marginal Effective Tax Rates are nil

Third, the numbers forwarded in the cash flow statement under an R-CFT tell us that the R-CFT would produce nil METRs. The R-CFT does not distort marginal investment decisions. The R-CFT shares this property with the ACE.

Accordingly, an R-CFT would operate equitably and neutrally at the margin. An R-CFT taxes excess earnings, Johnson's economic rent. Let us calculate METRs to illustrate things. Had Johnson's investment, for instance, yielded a pre-tax return of 4.01%, a business cash flow in our example of €1, the R-CFT imposed at a 25% rate would produce a tax on that business cash flow equal to €0.25.[1087] A pre-tax return of 4.0%, i.e., the marginal investment producing a marginal income equal to nil, would effectively entail a marginal tax liability of €0 also.[1088] That would produce the 0% METR.[1089]

5.7.2.6 Fixing the 'government's silent partnership' and 'financing discrimination' properties

Comparing R-CFT with ACE

Let us now compare the R-CFT with an ACE. First, the R-CFT trumps the ACE in the first round as the R-CFT lacks the 'tax depreciation should equal economic depreciation' issue. That is, although the issue under an ACE would be relatively moderate to the extent that matters are seen in present value terms; see section 56.2.2. However, second, the R-CFT's property comes with a price to be paid: government takes upon the role as a silent partner in all private investments, thereby exposing public revenue to private investor's risks. This basically ties the score, perhaps even renders the ACE to already win on points. Moreover, third, contrary to the ACE, the R-CFT does not resolve the financing discrimination issue as it proves to subsidize debt financing relative to equity financing. As the ACE lacks the latter two

[1086] 10,500 / 10,000 – 1 = 0.05.
[1087] 1.00 * 0.25 = 0.25. As said, the amount of additional €100 tax payable effectively equals the fisc's normal return rate to its capital investment as a silent partner in Johnson's venture (i.e., 0.04 * 2,500 = 100).
[1088] 0.00 * 0.25 = 0.00. Johnson's return to the invested equity capital of €60 in this example, equals the normal market return rate on the invested equity (i.e., 0.04 * 1,500 = 60).
[1089] See also Bond and Devereux who demonstrate the R-CFT's neutrality at the margin in Stephen R. Bond et al, 'Generalised R-based and S-based taxes under uncertainty', 87 *Journal of Public Economics* 1291 (2003), at 1291 – 1311.

problematic features that the adoption of an R-CFT would entail, the ACE, in my view, beats the R-CFT in the second and third round.

Modifying R-CFT; introducing 'tax credit carry forward at a normal market return rate'

The question arises as to whether it is possible to fix the R-CFT's two drawbacks. Zee demonstrates that it is.[1090] He shows that both the 'silent partnership' and 'debt subsidizing' properties of the R-CFT can be mitigated by transforming the expensing feature into a 'tax credit carry forward at the normal market return rate'.

Let us return to Johnson's investment in the dinghy selling activities to look into the effects of such a modification. These would be as follows (fig. 74):

Fig. 74. Johnson's 'Modified' R-CFT calculation

	Period 1	***Period 2***
Johnson's 'Modified' R-CFT calculation		
Earnings		
Gross Return on Investment	0	+ 10,500[1091]
Aggregate	0	+ 10,500
Costs		
Investment	– 10,000[1092]	0
Aggregate	– 10,000	+ 10,500
Tax Levy		
Aggregate (Taxable Amount)	– 10,000	+ 10,500
Tax*) (25%)	– 2,500[1093]	+ 2,625[1094]
Tax credit (at rate r)*)	+ 2,500[1095]	– 2,600[1096]
Tax payable	0[1097]	+ 25[1098]

*) A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax creditable.

Johnson's business activities produce the following business cash flows (fig. 75):

Fig. 75. Johnson's Cash Flow Statement

	Period 1	***Period 2***
Johnson's Cash Flow Statement		
Real Transactions ('R')		
Investment	– 10,000[1099]	
Gross Return on Investment		+ 10,500[1100]
Aggregate	– 10,000	+ 10,500
Financial Transactions ('F')		
Debt Issuance	+ 6,000[1101]	
Repayment Principal Amount		– 6,000[1102]
Interest Paid		– 240[1103]
Aggregate		– 6,240[1104]
Tax Levy		

[1090] See Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448.
[1091] 1 + ρ.
[1092] – 1
[1093] 0.25 * 10,000. Accordingly: – t.
[1094] 0.25 * 10,500. Accordingly: t.(1 + ρ).
[1095] + t.
[1096] 0.25 * 10,000 * 1.04 = 2,600. Accordingly: – t . (1 + r).
[1097] – t + t.
[1098] 0.25 * 100 = 25. Accordingly: t . (ρ – r).
[1099] – 1.
[1100] 1 + ρ.
[1101] α.
[1102] – α.
[1103] – α.r.
[1104] – α.(1 + r).

Tax*) (25%)	0[1105]	+ 25[1106]
Aggregate	– 4,000[1107]	+ 4,235[1108]

*) A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax refundable.

Under such a modification, the net outbound cash flow in period 1 would be restored to €4,000, an amount equal to the invested equity capital. The modification would effectively bring the tax in line, at this point, with the conventional corporate income tax, the CBIT and the ACE discussed in the above. The net inbound cash flow in period 2 would alter. The inflow in period 2 would now equal €4,235. Accordingly, that would entail the exact same amount as the period 2 inflow under an ACE. The net post-tax return to the invested equity capital ('$v_{modR\text{-}CFT}$') equals €235, a percentage of 5.875.[1109] What does this tell us?

That is, transforming R-CFT into an ACE

Basically, what we have just witnessed is the transformation of the R-CFT into an ACE. That is, with the exception of the tax depreciation feature.[1110] As of the modification, the R-CFT shares the properties of an ACE in producing equal to statutory AETRs, nil METRs and the property of operating neutrally towards the financing decision.

First, as regards AETRs, the modified R-CFT would produce equal to statutory AETRs of, in this case, 25%. Johnson would pay the same amount of tax he actually earns. Please let me demonstrate this. The canceling out of the expensing feature by transforming it into an interest carrying tax credit carry forward under the modified R-CFT, and with that, mitigating the role of government as silent partner, entails that the numerator and denominator in the fraction alter in comparison with the R-CFT. In our example, the numerator would change into €25 (instead of nil). That amount can be appreciated should one recognize that the tax authorities would return to sitting back and waiting until Johnson yields a return to subsequently be taxed (rather than to operate as a silent partner). The denominator would change into €100.

Government mitigates its role as silent partner under the modification

That amount (instead of €75) can be appreciated should one recognize that again, government basically ceases its role as silent partner. Silent partners' shares in the excess earnings may no longer be recognized.

The fisc returns to actually taxing Johnson's excess earnings rather than participating in the investment project. Taking these starting points for AETR calculation purposes, the AETR on Johnson's business cash flow under the modified R-CFT would equal 25%.[1111] The difference between the pre-tax return, 6.5% and the post-tax return, 5.875%, being 0.625%, equals the employed tax rate of 25% multiplied with Johnson's economic rent derived from its investment in the dinghy distribution business.[1112] Put forward otherwise, Johnson's pre-tax return exceeds the normal market return rate of 4% with 250 base points, so the return is 6.5%. Johnson's post-tax return equals 5.875%. That amount exceeds the normal market return rate

[1105] – t + t.
[1106] 0,25 * 100 = 25. Accordingly: t . (ρ – r).
[1107] – (1 – α). See also Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448.
[1108] (1 – α) + (ρ – α.r) – t.(ρ – r).
[1109] (4.235 / 4.000) – 1 = 0,05875. Accordingly: $v_{modR\text{-}CFT} = [(1 – \alpha) + (\rho – \alpha.r) – t.(\rho – r)] / (1 – \alpha) – 1 = (1 – t).(\rho – r) / (1 – \alpha) + r$. See also Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448. Note that the formula corresponds with its equivalent under an ACE with the exception of the tax depreciation component, as $v_{ACE} = [(1 – \alpha) + (\rho – \alpha.r) – t.(\rho – r) – t.(1 – d)] / (1 – \alpha) – 1 = (1 – t).(\rho – r) / (1 – \alpha) – t.(1 – d) / (1 – \alpha) + r$.
[1110] In addition, the tax would remain to tax cash flows, while the ACE would tax realized income or accrued income (i.e., regarding the latter if fair market value tax accounting would be adopted).
[1111] 25 / 100 * 100% = 25%.
[1112] 0.065 – 0.05875 = 0.25 * 100 / 4,000 Accordingly: $v – v_{modR\text{-}CFT} = t . (\rho – r) / (1 – \alpha)$. Note that the formula corresponds with its equivalent under an ACE with the exception of the tax depreciation component as $v – v_{ACE} = t.(\rho – r) . (1 – d) / (1 – \alpha)$.

of 4% with 187.5 base points. The difference between pre-tax and post-tax return rates equals 62.5 base points, and accordingly, an AETR of 25%.[1113]

Accordingly, provided that one recognizes that savings, the remuneration for the provision of capital, should not be taxed under a business income tax, as such a tax should merely tax the remuneration for the production factor of enterprise, the equal to statutory AETR under a modified R-CFT should be considered to enhance fairness relative to conventional corporate income tax and the CBIT. The modified R-CFT would share this property with the ACE. It takes some calculations, but in the end one gets what one sees, i.e., an effective tax imposed at a rate equal to the statutory tax rate. Again, this a fortiori holds true in cases where states tax savings under a portfolio investment income tax de facto producing an economic double taxation of savings income. [1114]

Nil METR; no financing discrimination issues

Second, as regards METRs, the marginal investment would produce a nil tax liability under an accordingly modified R-CFT. A pre-tax return of 4.0%, i.e., the marginal investment producing a marginal income equal to nil, would effectively entail a marginal tax liability of €0 also.[1115]

Third, as regards the risen financing discrimination issues under an R-CFT, Johnson would, upon the modification, be subject to a tax liability equal to €25 relating to its excess earnings, regardless of whether the investment in the dinghy selling activities is financed with debt, equity or a combination thereof. Accordingly, leverage effects would not alter relative to the no-tax environment.[1116]

Moreover, as a consequence of the tax credit carry forward property that replaced the expensing feature, government would cease to participate in Johnson's dinghy selling venture as a silent partner. Accordingly, government revenue would not be exposed to private investors' risks. Please note that the replacement of the expensing feature for a tax carry forward at the nominal amount would transform the R-CFT into a CBIT.

One drawback would remain

With Zee, however, one remaining drawback may be recognized. As said, the expensing feature in an R-CFT entails government revenue to be exposed to private investor's risks. This risk cannot be fully resolved by crediting forward the total net tax credits at the normal market return rate. In reality entrepreneurs typically undertake multiple and concurrent investments. Some of those will be successful, others will not. As the entrepreneur's overall profitability will be the combined outcome of both successful and unsuccessful investment projects, so will government revenue. Accordingly, society would still pay for unsuccessful business projects. That is, to the extent that the taxable rents derived from the successful investments decrease as they are set-off against the losses derived from the unsuccessful ones. To that extent, the principle of income accrual under the S-H-S concept of income would not be fully appreciated.

As is to be seen in the following subsections, this remaining issue may be resolved by reinforcing tax depreciation. Accordingly, in the end, things would boil down to a trade-off between the acceptance of government being subject to private investors' risks, i.e., at least to some extent, and the (administrative) question of how to keep tax depreciation and economic depreciation in line. But first, let us take a closer look at the other cash flow tax, the 'Real and Financial Transactions Based' or 'Share Based' cash flow tax. Notably, as

[1113] 62.5 / 250 * 100% = 25%.
[1114] The question of whether savings should be taxed in the first place, as said, is not considered in this study.
[1115] 0.00 * 0.25 = 0.00.
[1116] Indeed, as Johnson derives excess earnings from its dinghy distribution activities, the adoption of an modified R-CFT would enable him to push on the return to the invested equity capital by financing its investment in the dinghy distribution activity with a higher percentage of debt capital. However, contrary to the R-CFT, the return to equity rates would move at the same pace in comparison with the increase in return to equity rates in a no tax environment. Accordingly, to that extent, the tax operates neutral relative to the no tax environment.

previously stated, issues involving the attribution of the taxable base to taxing jurisdictions are discussed as an isolated matter in Chapter 6.

5.7.3 Effects under 'Real and Financial Transactions Based' or 'Share Based' Cash Flow Tax

5.7.3.1 General remarks

Economists also resort to R+F-CFTs and S-CFTs

As mentioned, the R-CFT is not the only cash flow tax that is advocated by economists. Let us recommence with the 'Real and Financial Transactions Based Cash Flow Tax' ('R+F-CFT') or 'Share Based Cash Flow Tax' ('S-CFT').[1117] The R+F-CFT recognizes as a taxable event all cash flows related to goods provided and services rendered, i.e., including cash flows related to financial (i.e., debt financing) transactions. The S-CFT recognizes as a taxable event all cash flows related to share transactions, i.e., equity financing arrangements.

As mentioned in section 5.7.1, there are no real conceptual differences to be recognized between an R+F-CFT and the S-CFT as the net inflow of real transactions and financial transactions, by accounting identity, necessarily equals the net outflow of share transactions (i.e., R + F = S).

The following exclusively refers to the term 'R+F'. It may nevertheless be appreciated that the term may be interchanged with 'S'. Similar to the R-CFT, the application of the R+F-CFT triggers tax refunds upon outward bound cash flows. The inward bound cash flows trigger liabilities to pay tax. However, contrary to the R-CFT and, notably, the European Union value added taxation as well, the R+F-CFT does not exclude financial transactions from the taxable base. There is no need, other than perhaps administratively, to distinguish between real transactions and financial transactions as, for instance, is the case under an R-CFT and European Union value added taxation. Moreover, the R+F-CFT includes wages in the taxable base, while European Union value added taxation does not.

Nominal tax payable; R+F-CFT corresponds with conventional CIT, but…

In terms of nominal amounts of tax payable, the R+F-CFT corresponds with the conventional corporate income tax, which taxes the nominal return to equity and allows for a deduction of wages and interest payments. Accordingly, in terms of nominal amounts of tax payable, the R+F-CFT is broader than, for instance, under the ACE.

However, in terms of effective tax burdens imposed, there is a vast difference to be recognized between the R+F-CFT on the one hand and the conventional corporate income tax and ACE on the other, as the first mentioned entails a tax refund to the taxpayer upon the outbound payment, i.e., the investment in period 1 and a tax payable upon the investment's return in period 2, while the conventional corporate income tax and ACE do not allow for tax refunds at the time of undertaking the investment in period 1. The latter tax systems merely recognize a taxable event at the time the respective investment yields a taxable return in period 2. Accordingly, contrary to the conventional corporate income tax and ACE, interest yielding funds become available upon the investment under the R+F-CFT. However, if that property would be cancelled out, the R+F-CFT would turn out to operate conceptually in a manner surprisingly akin to an ACE. Let us proceed with the analysis.

5.7.3.2 The effects involving a direct investment

[1117] For some further discussion, see Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008).

Assessing the investment returns of 'Ben Johnson Dinghy Selling Company'

Let us return to our taxpayer Johnson and its dinghy business activities. As previously stated, Johnson directly invests in a dinghy sales activity. Let us suppose that the tax rate equals a linear 25%. Under an R+F-CFT, the effects are as follows (fig. 76):

Fig. 76. Johnson's R+F-CFT calculation

	Period 1	***Period 2***
Johnson's R+F-CFT calculation		
Earnings		
Gross Return on Investment		+ 10,500[1118]
Debt Issuance	+ 6,000[1119]	
Aggregate	+ 6,000	+ 10,500
Costs		
Investment	– 10,000[1120]	
Repayment Principal Amount		– 6,000[1121]
Interest Paid		– 240[1122]
Aggregate	– 10,000	– 6,240[1123]
Tax Levy		
Aggregate (Taxable Amount)	– 4,000[1124]	+ 4,260[1125]
Tax*) (25%)	– 1,000[1126]	+ 1,065[1127]

*) A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax refundable.

Johnson's business activities produce the following business cash flows (fig. 77):

Fig. 77. Johnson's Cash Flow Statement

	Period 1	***Period 2***
Johnson's Cash Flow Statement		
Real Transactions ('R')		
Investment	– 10,000[1128]	
Gross Return on Investment		+ 10,500[1129]
Aggregate	– 10,000	+ 10,500
Financial Transactions ('F')		
Debt Issuance	+ 6,000[1130]	
Repayment Principal Amount		– 6,000[1131]
Interest Paid		– 240[1132]
Aggregate	+ 6,000	– 6,240[1133]
Tax Levy		
Tax*) (25%)	– 1,000[1134]	+ 1,065[1135]
Aggregate	– 3,000[1136]	+ 3,195[1137]

*) A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax refundable.

[1118] 1 + ρ.
[1119] α.
[1120] – 1
[1121] – α.
[1122] – α.r.
[1123] – α.(1 + r).
[1124] (1 – α).
[1125] (1 – α) + (ρ – α.r).
[1126] 0.25 * 4,000 = 1,000. Accordingly: – t.(1 – α).
[1127] 0.25 * 4,260 = 1,065. Accordingly: t.[(1 – α) + (ρ – α.r)].
[1128] – 1.
[1129] 1 + ρ.
[1130] α.
[1131] – α.
[1132] – α.r.
[1133] – α.(1 + r).
[1134] – t.(1 – α).
[1135] t.[(1 – α) + (ρ – α.r)].
[1136] – (1 – t).(1 – α). See also Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448.
[1137] (1 – t).[(1 – α) + (ρ – α.r)]. See also Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448.

The net outward bound cash flow in period 1 alters in comparison with the no-tax environment and in comparison with the aforementioned taxes (conventional corporate income tax, CBIT, ACE and R-CFT). The investment transaction in period 1 constitutes a taxable event triggering a tax refund. Consequently, the outward bound cash flow in period equals €3,000 rather than €4,000. The net inward bound cash flow in period 2 also alters. This time, the inflow in period 2 equals 3,195. The post-tax return to the invested equity capital ('$v_{R+F\text{-}CFT}$') equals €195, a percentage of 0.065.[1138] These numbers again tell us three things (see sections 5.7.3.3, 5.7.3.4, and 5.7.3.5).

5.7.3.3 Average Effective Tax Rates are nil; Property comes with a Price

What would be the AETR?

First, it tells us something about the AETR under an R+F-CFT. The application of an R+F-CFT produces a tax payable of €65. However, similar to the R-CFT the question arises to which extent Johnson effectively bears the tax.

A closer look at the R+F-CFT reveals that one may ask again whether the R+F-CFT actually results into Johnson bearing a tax impost. It rather seems that the R+F-CFT shares the R-CFT's property of triggering the tax authorities to engage in a private investment as a silent partner in Johnson's distribution activities yielding a return of €65 (i.e., 1,065 – 1,000).[1139] The amount of €65 tax payable effectively breaks down in two components again: a component corresponding to the financing costs relating to the fisc's capital investment (€40 financing costs) and a component corresponding with an amount payable relating to the fisc's excess earnings (€25). In period 1, Johnson's investment entails a refund from the tax authorities at an amount of €1,000.

This can be interpreted as a private investment undertaken by the government. Namely, the fisc makes these funds available to Johnson. Taking the debt issuance into account as well, Johnson's actual equity investment accordingly accounts for a mere €3,000 rather than the nominal amount of €4,000 which we saw earlier. That amount of €3,000 would equal the amount of Johnson's actual equity at risk. From the fisc's perspective, its investment of €1,000 turns out to produce a return of €65, a return rate of 6.5%.[1140] That number equals the return on the investment absent a tax impost. This time, the silent partner's share in the excess earnings equals Johnson's. As a comparison, the fisc would have settled for a 5% return under the R-CFT. A deposit on a savings account at the normal market rate of 4% would yield the €1,000 investment to return €40. Hence, an amount of €40 corresponds with the normal market rate return on the fisc's capital investment. From Johnson's perspective, this amount of €40 equals the costs of capital made available by its silent partner, the tax authorities.

Consequently, the excess of €25 (i.e., 65 – 40) can be understood as the fisc's 'excess earnings' (i.e., a 2.5% excess return[1141]) on its €1,000 investment in Johnson's business. Perhaps, that latter amount, i.e., from Johnson's perspective, may be understood to equal the tax burden imposed on the economic rents of, in this case, €100 on the investment in the dinghy distribution business. That amount of €100 economic rents can be understood as follows. The investment of €10,000 in the dinghy selling activities produces a gross return of €500. The interest paid on the bank loan of €6,000 equals €240. The cost of capital relating to the fisc's investment of €1,000 equals €40. The opportunity cost of capital relating to Johnson's equity investment of €3,000 equals 120.[1142] Consequently, the aggregate amount

[1138] (3,195 / 3,000) – 1 = 0.065. Accordingly: $v_{R+F\text{-}CFT} = (1 – t).[(1 – \alpha) + (\rho – \alpha.r) / (1 – t).(1 – \alpha) – 1 = (\rho – r) / (1 – \alpha) + r$. Note that $v_{R+F\text{-}CFT} = v$, as $v = (\rho – r) / (1 – \alpha) + r$. Accordingly: $v – v_{R+F\text{-}CFT = 0}$.
[1139] See also Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010. Auerbach recognizes this effect under its destination based CFT proposal, yet does not seem to have a problem with this.
[1140] (1,065 / 1,000) – 1 = 0.065.
[1141] 25 / 1,000 * 100 = 2.50%.
[1142] 0.04 * 3,000 = 120.

of €100 (i.e., 500 – 240 – 40 – 120 = 100) equals the excess earnings triggering the amount of what may *de facto* be understood as a tax burden of €25.[1143]

However, alternatively, the amount of €25 tax payable to the tax authorities (in excess of the €40) may also be considered to equal the fisc's share of excess earnings as silent partner in Johnson's dinghy distribution business. If one considers this latter amount of €25 to constitute the fisc's/silent partner's share of excess earnings, this qualification would render the R+F-CFT not to be borne by Johnson at all. Namely, Johnson's pre-tax excess earnings would then equal its post-tax excess earnings. In such a case, the amount of Johnson's pre-tax economic rents would be calculated as €75. That amount can be understood as follows. The investment of €10,000 in the dinghy selling activities produces a gross return of €500. The interest paid on the bank loan of €6,000 equals €240. The cost of capital relating to the fisc's investment of €1,000 equals €40. The opportunity cost of capital relating to Johnson's equity investment of €3,000 equals €120.

In addition, the fisc's excess earnings relating to its capital investment as a silent partner, equals €25. Consequently, the aggregate amount of €75 (i.e., 500 – 240 – 40 – 120 – 25 = 75) would constitute Johnson's pre-tax excess earnings, taking the silent partner's share into account. The pre-tax excess earnings would be equal to Johnson's post-tax excess earnings of €75 (i.e., 500 – 240 – 100 – 60 – 25 = 75). That would accordingly render the R+F-CFT not to be borne by Johnson at all. In my view, this would be the proper finding.

Notably, the expensing feature is what the R+F-CFT distinguishes from, for instance, the conventional corporate income tax, which in this case would produce an overall amount of €65 tax payable as borne by Johnson. Contrary to the R+F-CFT, that amount would not break down into components since the conventional corporate income tax lacks the expensing feature. Under a conventional corporate income tax (or CBIT and ACE for that matter) government would not operate as a silent partner. It would merely sit back and wait until Johnson yields a return to subsequently tax it. Again, the question may arise as to which extent an R+F-CFT actually still is a tax.

Let us proceed calculating AETRs. As said, AETRs are calculated by dividing the tax payable (numerator) by the pre-tax income (denominator).[1144] The question again arises as to which numbers need to be put into the fraction.[1145] As we have seen in the above paragraph, in respect of the amount to be adopted in the *numerator*, a decision out of three available options needs to be made. The available numbers are €65, €25 and nil. Things depend on whether and to which extent the tax authorities' position as silent partner in Johnson's investment in the dinghy distribution business should be recognized for AETR calculation purposes. With respect to the amount to be adopted in the *denominator*, various figures are potentially available as well.

In this respect, the remarks referred to in the above should be both repeated and supplemented. As discussed, in a no-tax environment, the net return on the investment in the dinghy distribution business equals €260. Taking the application of the R+F-CFT into account, this amount comprises of two components, both of which subsequently can be subdivided into two subcomponents (entailing an aggregate of four subcomponents). The first component amounts to €160. It refers to the 4% normal market return rate on the €6,000 equity investment. Contrary to alternative tax bases discussed earlier, this amount of €160 may subsequently be broken up into two subcomponents. The first equals an amount of €40 corresponding to the fisc's normal market rate return on its €1,000 investment as a silent partner. The second subcomponent equals an amount of €120 corresponding to Johnson's normal market rate return on its €3,000 equity investment (i.e., the opportunity costs of capital). The second component amounts to €100. It refers to the excess earnings, the

[1143] 0.25 * 100 = 25.

[1144] See Willem Vermeend et al, *Taxes and the Economy; a Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 73.

[1145] See for a comparison Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, who refer to concerns as to whether it is suitable to find a proper measure of profit to uses as the denominator.

remuneration for the production factor of enterprise. Contrary to alternative tax bases discussed earlier, this amount of €100 may subsequently be broken up into two components as well. Viz., an amount of €25 corresponding to the fisc's share of the excess earnings in return on its €1,000 investment as silent partner (i.e., the 2.5% return in excess of the 4% normal market rate return) and the remaining amount of €75 corresponding to Johnson's share of the excess earnings in return on its equity investment of €3,000 (i.e., the 2.5% return in excess of the 4% normal market rate return[1146]). As said, again, the question arises as to which of these numbers should be taken into consideration? Which numbers should be picked?

Similar to the R-CFT, the numbers to pick, in my view, are nil (numerator) and €75 (denominator). This produces a nil AETR.[1147] Why is that? The amount of nil in the numerator can be appreciated should one recognize that the fisc actually invests as a silent partner in Johnson's business. This effect has been caused by the R+F-CFT's expensing feature it shares with the R-CFT. The amount of €75 in the denominator can be appreciated if one recognizes that pre-tax business cash flow, i.e., the earnings exceeding the normal market rate of return, should be taken into consideration as denominator for AETR calculation purposes. All financing costs, including the opportunity costs of capital, are actual costs. The fact that the pre-tax business cash flow accounts for €75 rather than €100 (which is the case under the tax bases discussed in the above with the exception of the R-CFT) can be appreciated if one recognizes the fisc's performance as silent partner. The R+F-CFT's expensing feature triggers the fisc to operate as a silent partner in the dinghy distribution business yielding both a normal market rate return (€40) as well as excess earnings (€25). This observation renders Johnson's pre-tax excess earnings equal its post-tax excess earnings, i.e., €75. Moreover, as the fisc does not settle for a return rate that differs from Johnson's, the R+F-CFT enables Johnson to derive a net return on its equity investment equal to the return in a no tax environment, i.e., 6.5%. That would be contrary to the R-CFT, as that tax would enable Johnson to derive a 9% return.

'Tax depreciation should correspond with economic depreciation issues' do not emerge

This being said, moreover, contrary to some of its counterpart taxation methods discussed in the above, i.e., the conventional corporate income tax, and the CBIT (and similar to the R-CFT) no 'tax depreciation should correspond with economic depreciation issues' emerge. Due to the expensing feature, the R+F-CFT has in common with the R-CFT and European Union value added taxation the following: i.e., Johnson's investment triggers a tax refund in period 1, tax depreciation is non-existent and, hence, by its nature, cannot trigger this issue as presented under the earlier discussed alternatives.

Notably, similar to the remarks made in respect of the R-CFT, this does not necessarily entail that R+F-CFTs would resolve issues on the question of where, i.e., in which state, the tax should be paid. Investment location distortions may still occur as a result of mutual tax rate divergences to the extent that the taxable base, as is currently the case in international taxation, is attributed to taxing jurisdictions by means of origin based profit allocation factors. The adoption of an 'origin based' R+F-CFT would not change this. The effects are difficult to predict. Relatively higher rates employed would entail relatively higher tax refunds. The opposite would be true under relatively lower rates. I am not sure what the outcome would be. In addition, I am also not sure whether the R+F-CFT, to this extent, would be able to put the current 'race to the bottom' problem referred to previously to an end. This being said, interestingly, contrary to the R-CFT, the introduction of a tax rate increase in our example – let us for instance again increase the rate from 25% to, say, 30% – would not entail a mutation in post-tax investment returns ('$v_{R+F-CFT}$'). Indeed, the post-tax return to the invested equity capital would drop to €182 (instead of €195).[1148] Yet, that would effectively entail a

[1146] 75 / 3,000 * 100 = 2.50%.
[1147] 0 / 75 = 0.
[1148] 2,982 – 2,800 = 182.

post-tax return rate of 6.5%, i.e., a return equal to the return under a 25% tax rate.[1149] Contrary to the R-CFT, a tax rate increase would not drive post-tax earnings upwards. The potential of 'racing to the top', as tentatively recognized under an origin-based R-CFT, accordingly, would be absent under an origin-based R+F-CFT. As said, the attribution of a taxable base to taxing jurisdictions is further discussed as an isolated issue in Chapter 6.

Absence of tax depreciation issues comes with a price; society engages in taking on private investment risks

Nevertheless, the absence of issues involving tax depreciation under an R-CFT again comes with a price similar to that under an R-CFT. That price paid is absent under the alternative tax bases discussed in the above (corporate income tax, CBIT, ACE).

As said, the expensing feature under an R+F-CFT entails that society, as represented by the government, would engage in private investment undertakings as a silent partner in all private investments undertaken by taxpayers. In our example, the government's stake in Johnson's investment equals €1,000. Thereby, Johnson's private investor's risks are partly transferred to society.

Accordingly, under an R+F-CFT, government revenue would be exposed to the exact same investment risks as those faced by private investors.[1150] Despite the fact that the amount of community funds at risk is lower in comparison with the R-CFT, under which, government would invest €2,500, the provision of public goods, as financed by tax revenues, would be subject to these risks as well. This role of government as a silent partner may be considered an inherent limitation of the R+F-CFT, as many perhaps would agree that the financing of public goods should not be subject to private investors' risks. The R+F-CFT shares this property with the R-CFT (yet the absolute scope of funds at risk would be less). Many would perhaps agree that governments should impose tax rather than act as silent partners in business ventures. Note that the ACE lacks this feature. Under an ACE, government would not be subject to these private investor's risks as recognized under an R-CFT.

Hence, again something needs to be done about the expensing feature. However, before getting to potential solutions for the issues triggered by the expensing feature of an R-CFT, some additional remarks should be made regarding the R+F-CFT's properties.

5.7.3.4 Financing Discrimination Issues Mitigated

Second, the numbers forwarded in the cash flow statement above tell us something about the effects of financing decisions under an R+F-CFT. The cash flow calculations demonstrate that Johnson's post-tax return rate under an R+F-CFT ('$v_{R+F\text{-}CFT}$' = 6.5%) equals the return rate in a no tax environment (v = 6.5%). What does this tell us?

This can be explained by recognizing that, contrary to the R-CFT, the R+F-CFT does not subsidize debt financing relative to equity financing in cases where investments yield economic rents. The R+F-CFT does not affect the return rate whatsoever. Regardless of Johnson's financing decision, the return rate under an R+F-CFT would equal the return rate in a no tax environment. Had Johnson financed the dinghy sales activity entirely with equity,[1151] the R+F-CFT would have produced a nominal overall amount of €125 tax payable, i.e., the aggregate of a tax refund equal to €2,500 in period 1 and a tax payable equal to €2,625 in period 2. The fisc settles consistently for a return on its investment as silent partner equal to Johnson's. Viz., Johnson's return to the invested equity of, this time, €7,500, would equal €375 (i.e., 7,875 – 7,500), a return to equity rate of 5%.[1152] That would match the return to equity rate in a no tax environment (provided that Johnson had financed its investment

[1149] (2,982 / 2,800) – 1 = 0.065. Notably, a tax rate of 35% would entail a post-tax return rate of 6.5% as well: (2,769 / 2,600) – 1 = 0.065.
[1150] See also Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448.
[1151] 1 – α = 1 (α = 0).
[1152] 7,875 / 7,500 – 1 = 0.05.

entirely with equity).[1153] Accordingly, as Johnson derives excess earnings from its dinghy selling activities, the adoption of an R+F-CFT, contrary to the R-CFT, would not enable him to push on the return to the invested equity capital by financing its investment in the dinghy sales activity with a higher percentage of debt capital. The return to equity rate would increase at the exact same pace as the increase in return to equity rates would have been in a no tax environment.[1154] The leverage effects are identical. This is caused by the fact that the R+F-CFT does not distinguish between real and financial transaction. Accordingly, the R+F-CFT proves not to subsidize debt financing relative to equity financing in a similar manner as the R-CFT does. Hence, it would not encourage taxpayers to finance their investments with as much debt as possible. The R+F-CFT operates neutrally towards the financing decision. Accordingly, the R+F-CFT shares this property with the ACE as discussed in section 5.6. In my view, as this entails neutrality towards financing decisions, this financing neutrality provides an equitable feature of an R+F-CFT, which it shares with the ACE.

5.7.3.5 Marginal Effective Tax Rates are nil

Third, the numbers forwarded in the cash flow statement under an R+F-CFT tell us that the R+F-CFT would produce nil METRs. The R+F-CFT does not distort marginal investment decisions. It shares this property with both the R-CFT and the ACE. Accordingly, an R+F-CFT would operate equitably and neutrally at the margin. An R-CFT merely taxes excess earnings, or Johnson's economic rent, as an example. Let us calculate METRs to illustrate things. Had Johnson's investment, for instance, yielded a pre-tax return of 4.01%, a business cash flow in our example of €1, the R-CFT imposed at a 25% rate would produce a tax on that business cash flow equal to €0.25.[1155] A pre-tax return of 4.0%, i.e., the marginal investment producing a marginal income equal to nil, would effectively entail a marginal tax liability of €0 also.[1156] That would produce the 0% METR.[1157]

5.7.3.6 Fixing the 'government's silent partnership' feature

Let us compare the R+F-CFT with an ACE. First, the R+F-CFT seems to trump the ACE in the first round as the R+F-CFT lacks the 'tax depreciation should equal economic depreciation' issue. That is, although the issue under an ACE would be relatively moderate to the extent that matters are seen in present value terms; see section 5.6.2.2. However, second, the R-CFT's property comes with a price to be paid: government takes upon the role as a silent partner in all private investments thereby exposing public revenue to private investor's risks. This basically ties the score. Moreover, the score remains tied as the R+F-CFT, contrary to the R-CFT, shares the ACE's property of resolving the financing discrimination issue.

Modifying R+F-CFT; introducing 'tax credit carry forward at normal market return rate'

The question again arises as to whether it is possible to fix the R+F-CFT drawback. Zee demonstrates that it is.[1158] He shows that the 'silent partnership' property of the R+F-CFT can

[1153] 10,500 / 10,000 – 1 = 0.05.
[1154] Indeed, as Johnson derives excess earnings from its dinghy distribution activities, the adoption of a modified R+F-CFT would enable him to push on the return to the invested equity capital by financing its investment in the dinghy distribution activity with a higher percentage of debt capital. However, contrary the return to equity rates would move at the same pace in comparison with the increase in return to equity rates in a no tax environment. Accordingly, to that extent, the tax operates neutral relative to the no tax environment.
[1155] 1.00 * 0.25 = 0.25. As said, the amount of additional €40 tax payable effectively equals the fisc's normal return rate to its capital investment as a silent partner in Johnson's venture (0.04 * 1,000 = 40).
[1156] 0.00 * 0.25 = 0.00. Johnson's return to the invested equity capital of €120, in this example, equals the normal market return rate on the invested equity (i.e., 0.04 * 3,000 = 120).
[1157] See also Bond and Devereux who demonstrate the R+F-CFT's (and equivalently the S-CFT's) neutrality at the margin in Stephen R. Bond et al, 'Generalised R-based and S-based taxes under uncertainty', 87 *Journal of Public Economics* 1291 (2003), at 1291 – 1311. The authors also discuss the effects of debtor defaults under the various CFTs. This is not further discussed.
[1158] See Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448.

be mitigated by transforming the expensing feature into a 'tax credit carry forward at the normal market return rate'.

Let us return to Johnson's investment in the dinghy selling activities to illustrate the effects of such a modification. These would be as follows (fig. 78):

Fig. 78. Johnson's Modified' R+F-CFT calculation

	Period 1	***Period 2***
Johnson's Modified' R+F-CFT calculation		
Earnings		
Gross Return on Investment		+ 10,500[1159]
Debt Issuance	+ 6,000[1160]	
Aggregate	+ 6,000	+ 10,500
Costs		
Investment	– 10,000[1161]	
Repayment Principal Amount		– 6,000[1162]
Interest Paid		– 240[1163]
Aggregate	– 10,000	– 6,240[1164]
Tax Levy		
Aggregate (Taxable Amount)	– 4,000[1165]	+ 4,260[1166]
Tax*) (25%)	– 1,000[1167]	+ 1,065[1168]
Tax credit (at rate r)*)	+ 1,000[1169]	– 1,040[1170]
Tax payable	0[1171]	+ 25[1172]

*) A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax refundable.

Johnson's business activities produce the following business cash flows (fig. 79):

Fig. 79. Johnson's Cash Flow Statement

	Period 1	***Period 2***
Johnson's Cash Flow Statement		
Real Transactions ('R')		
Investment	– 10,000[1173]	
Gross Return on Investment		+ 10,500[1174]
Aggregate	– 10,000	+ 10,500
Financial Transactions ('F')		
Debt Issuance	+ 6,000[1175]	
Repayment Principal Amount		– 6,000[1176]
Interest Paid		– 240[1177]
Aggregate	+ 6,000	– 6,240[1178]
Tax Levy		
Tax*) (25%)	0[1179]	+ 25[1180]

[1159] 1 + ρ.
[1160] α.
[1161] – 1
[1162] – α.
[1163] – α.r.
[1164] – α.(1 + r).
[1165] (1 – α).
[1166] (1 – α) + (ρ – α.r).
[1167] 0.25 * 4,000 = 1,000. Accordingly: – t.(1 – α).
[1168] 0.25 * 4,260 = 1,065. Accordingly: t.[(1 – α) + (ρ – α.r)].
[1169] + t.(1 – α).
[1170] 0.25 * 4,000 * 1.04 = 1,040. Accordingly: – t . (1 + r).
[1171] – t.(1 – α) + t.(1 – α).
[1172] 0.25 * 100 = 25. Accordingly: t . (ρ – r).
[1173] – 1.
[1174] 1 + ρ.
[1175] α.
[1176] – α.
[1177] – α.r.
[1178] – α.(1 + r).
[1179] – t.(1 – α) + t.(1 – α).
[1180] 0.25 * 100 = 25. Accordingly: t . (ρ – r).

Aggregate	– 4,000[1181]	+ 4,235[1182]

***)** A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax refundable.

Under such a modification, the net outward bound cash flow in period 1 would be restored to €4,000, an amount equal to the invested equity capital. The modification would effectively bring the tax in line, at this point, with the conventional corporate income tax, the CBIT and the ACE discussed in the above. The net inward bound cash flow in period 2 would alter. The inflow in period 2 would now equal €4,235. Accordingly, that would entail the exact same amount as the period 2 inflow under an ACE. The net post-tax return to the invested equity capital ('$v_{modR+F-CFT}$') equals €235, a percentage of 5.875.[1183] What does this tell us?

That is, transforming R+F-CFT into an ACE

Indeed, what we have just witnessed, basically, is the transformation of the R+F-CFT into an ACE. That is, with the exception of the tax depreciation feature.[1184] Similar to the modified R-CFT, as of the modification, the R+F-CFT shares the properties of an ACE of producing equal to statutory AETRs, nil METRs and the feature of operating neutrally towards the financing decision.

First, as regards AETRs, the modified R+F-CFT would produce AETRs that are equal to the statutory tax rate of, in this case, 25%. Johnson would pay the same amount of tax he actually earns. Please let me demonstrate this. The canceling out of the expensing feature under the modified R+F-CFT, and with that, the role of government as silent partner, entails that the numerator and denominator in the fraction alter in comparison with the R+F-CFT. In our example, the numerator would change into €25 (instead of nil).

Government mitigates its role as silent partner under the modification

That amount can be appreciated should one recognize that the tax authorities would return to sitting back and waiting until Johnson yields a return to subsequently tax (rather than operating as a silent partner). The denominator would change into €100 (instead of €75). That amount can be appreciated should one recognize that, again, government ceases its role as silent partner. Silent partners' shares in the excess earnings may no longer be recognized. The fisc returns to actually taxing Johnson's excess earnings rather than participating in the investment project. Taking these starting points for AETR calculation purposes, the AETR on Johnson's business cash flow under the modified R+F-CFT would equal 25%.[1185] The difference between the pre-tax return of 6.5% and the post-tax return of 5.875% is 0.625%, and equals the employed tax rate of 25% multiplied by Johnson's economic rent derived from its investment in the dinghy distribution business.[1186] Put forward otherwise, Johnson's pre-tax return of 6.5% exceeds the normal market return rate of 4% with 250 base points. Johnson's post-tax return equals 5.875%. That amount exceeds the normal market return rate of 4% with 187.5 base points. The difference between Johnson's pre-tax and post-tax return rates equals 62.5 base points, and accordingly, an AETR of 25%.[1187]

[1181] – (1 – α). See also Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448.

[1182] (1 – α) + (ρ – α.r) – t.(ρ – r).

[1183] (4,235 / 4,000) – 1 = 0.05875. Accordingly: $v_{modR+F-CFT} = [(1 – α) + (ρ – α.r) – t.(ρ – r)] / (1 – α) – 1 = (1 – t).(ρ – r) / (1 – α) + r$. See also Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448. Note that the formula corresponds with the modified R-CFT as $v_{modR-CFT} = (1 – t).(ρ – r) / (1 – α) + r$. as well. Moreover, $v_{modR+F-CFT}$ matches its equivalent under an ACE with the exception of the tax depreciation component, as $v_{ACE} = [(1 – α) + (ρ – α.r) – t.(ρ – r) – t.(1 – d)] / (1 – α) – 1 = (1 – t).(ρ – r) / (1 – α) – t.(1 – d) / (1 – α) + r$.

[1184] In addition, the tax would remain to tax cash flows, while the ACE would tax realized income or accrued income (i.e., regarding the latter if fair market value tax accounting would be adopted).

[1185] 25 / 100 * 100% = 25%.

[1186] 0.065 – 0.05875 = 0.25 * 100 / 4,000. Accordingly: $v – v_{modR-CFT} = t . (ρ – r) / (1 – α)$. Note that the formula corresponds with its equivalent under an ACE with the exception of the tax depreciation component as $v – v_{ACE} = t.(ρ – r) . (1 – d) / (1 – α)$.

[1187] 62.5 / 250 * 100% = 25%.

Accordingly, provided that one recognizes that savings, or the remuneration for the provision of capital, should not be taxed under a business income tax, as such a tax should merely tax the remuneration for the production factor of enterprise, the equal to statutory AETR under a modified R-CFT should be considered to enhance fairness relative to conventional corporate income tax and the CBIT. The modified R-CFT would share this property with the ACE. In the end one gets what one sees, i.e., an effective tax imposed at a rate equal to the statutory tax rate. Again, this a fortiori holds true in cases where states tax savings under a portfolio investment income tax de facto producing an economic double taxation of savings income.[1188]

Nil METR, and no financing discrimination issues

Second, as regards METRs, the marginal investment would produce a nil tax liability under an accordingly modified R-CFT. A pre-tax return of 4.0%, i.e., the marginal investment producing a marginal income equal to nil, would effectively entail a marginal tax liability of €0 also.[1189]

Third, no financing discrimination issues would arise. Johnson would be subject to a tax liability equal to €25 relating to its excess earnings regardless of whether the investment in the dinghy selling activities is financed with debt, equity or a combination thereof. Accordingly, leverage effects would not alter relative to the no-tax environment.

Moreover, as a consequence of the tax credit carry forward property that replaced the expensing feature, government would not participate in Johnson's venture as a silent partner. Accordingly, in that respect, government revenue would not be exposed to private investors' risks. Please note that the replacement of the expensing feature for a tax carry forward at the nominal amount would transform the R+F-CFT into a conventional corporate income tax.

Again, one drawback would remain

With Zee, however, again one remaining drawback may be recognized. As said, the expensing feature in an R+F-CFT entails government revenue to be exposed to private investor's risks. Again, this risk cannot be fully resolved by crediting forward the total net tax credits at the normal market return rate. As previously stated, in reality entrepreneurs typically undertake multiple and concurrent investments. Some of those will be successful, others will not. As the entrepreneur's overall profitability will be the combined outcome of both successful and unsuccessful investment projects, so will government revenue. Accordingly, society would still pay for unsuccessful business projects, at least to some extent. That is, to the extent that the taxable rents derived from the successful investments decrease as they are set-off against the losses derived from the unsuccessful ones. To that extent again the principle of income accrual under the S-H-S concept of income would not be fully appreciated.

5.7.3.7 Reinforcing tax depreciation?

This remaining issue may be resolved by reinforcing tax depreciation, i.e., in a manner common to typical tax depreciation under conventional corporate income tax, CBIT and ACE taxation systems.[1190] This could be done by altering the tax credit carry forward calculations

[1188] The question of whether savings should be taxed in the first place is not considered in this study.
[1189] 0.00 * 0.25 = 0.00.
[1190] Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 *De Economist* 417 (2007), at 417-448, suggests doing so by replacing the expensing feature with tax depreciation of fixed assets. Moreover, he argues to subsequently allow for a carry forward of the undepreciated value of fixed assets at the opportunity cost of equity capital. For this purpose, Zee argues to extract the investment (1) from the tax calculation in period 1 and to grant a tax deduction in period 2 (1 + r). The latter component would represent the depreciation allowance with interest. Zee for simplicity reasons assumes the depreciation allowance to correspond with true economic depreciation (1 = d). Indeed, that would not resolve the 'tax depreciation should equal economic depreciation' issue recognized in the above. In addition, if I understand correctly, Zee, accordingly, basically argues to transform the modified R+F-CFT into a 'F-CFT', i.e., a cash flow tax on financial transactions. Viz., Zee recognizes a taxable event in period 1, i.e., in respect of the inflow of funds upon the debt issuance (t. α), triggering an amount of tax payable. Zee further argues that taxpayers could neutralize this by engaging into an appropriate series of financial transactions subsequently triggering a tax payable as well. I have some difficulties understanding this. I do not understand why the undertaking of a debt financed investment activity should trigger a tax payable. Moreover, I do

under the modified R+F-CFT by replacing the investment component ('1') for a depreciation component ('d'). That would entail the carry forward of the undepreciated value of fixed assets at the opportunity cost of equity capital.

Let us return to Johnson's investment in the dinghy selling activities to illustrate the effects of such a modification. These would be as follows (fig. 80):

Fig. 80. Johnson's Modified' R+F-CFT calculation

	Period 1	***Period 2***
Johnson's Modified' R+F-CFT calculation		
Earnings		
Gross Return on Investment		+ 10,500[1191]
Debt Issuance	+ 6,000[1192]	
Aggregate	+ 6,000	+ 10,500
Costs		
Investment	– 10,000[1193]	
Repayment Principal Amount		– 6,000[1194]
Interest Paid		– 240[1195]
Aggregate	– 10,000	– 6,240[1196]
Tax Levy		
Aggregate (Taxable Amount)	– 4,000[1197]	+ 4,260[1198]
Tax*) (25%)	– 1,000[1199]	+ 1,065[1200]
Tax credit (at rate r)*)	+ 1,000[1201]	– 1,040[1202]
Tax payable	0[1203]	+ 25[1204]

*) A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax refundable.

Johnson's business activities produce the following business cash flows (fig. 81):

Fig. 81. Johnson's Cash Flow Statement

	Period 1	***Period 2***
Johnson's Cash Flow Statement		
Real Transactions ('R')		
Investment	– 10,000[1205]	
Gross Return on Investment		+ 10,500[1206]
Aggregate	– 10,000	+ 10,500
Financial Transactions ('F')		
Debt Issuance	+ 6,000[1207]	
Repayment Principal Amount		– 6,000[1208]
Interest Paid		– 240[1209]
Aggregate	+ 6,000	– 6,240[1210]

not understand why taxpayers subsequently should borrow funds to finance that tax payable. I have the impression that the 'depreciation' for 'investment' replacement should be introduced at another place in the scheme. I would suggest choosing a different path by calculating the tax credit alternatively, i.e., by means of replacing the 'investment' ('1') for 'depreciation' ('d').

[1191] 1 + ρ.
[1192] α.
[1193] – 1
[1194] – α.
[1195] – α.r.
[1196] – α.(1 + r).
[1197] (1 – α).
[1198] (1 – α) + (ρ – α.r).
[1199] 0.25 * 4,000 = 1,000. Accordingly: – t.(1 – α).
[1200] 0.25 * 4,260 = 1,065. Accordingly: t.[(1 – α) + (ρ – α.r)].
[1201] + t.(d – α).
[1202] 0.25 * 4,000 * 1.04 = 1,040. Accordingly: – t . (d + r).
[1203] – t.(1 – α) + t.(d – α) as d = 1.
[1204] 0.25 * [(500 – 400) + (10,000 – 10,000)] = 25. Accordingly: t.[(ρ – r) + (1 – d)].
[1205] – 1.
[1206] 1 + ρ.
[1207] α.
[1208] – α.
[1209] – α.r.
[1210] – α.(1 + r).

Tax Levy		
Tax*) (25%)	0[1211]	+ 25[1212]
Aggregate	– 4,000[1213]	+ 4,235[1214]

*) A tax preceded by a '+' sign represents an amount of tax payable. A tax preceded by a '–' sign represents an amount of tax refundable.

Under such a modification, the net outward bound cash flow in period 1 would remain to be restored to €4,000, an amount equal to the invested equity capital. The net inward bound cash flow in period 2 would not alter.[1215] The inflow in period 2 would again equal €4,235. The net post-tax return to the invested equity capital ('$v_{modR+F-CFTdepreciation}$') equals €235, a percentage of 5.875.[1216] What does this tell us?

Modifications drive towards advocating ACE; moving in a circle

Interestingly, the modifications drove us towards substantially advocating the ACE. We have moved in a circle. The re-introduction of tax depreciation and the interest carrying tax credit carry forward features that have rendered the R+F-CFT identical to the ACE.

With the depreciation feature, the transformation of the tax into the ACE is complete. Notably, to prevent tax cascading, intra-group transactions regarding controlled subsidiaries should not be recognized. In addition, an indirect tax exemption should be adopted with respect to non-controlling equity interests in participations. As the R+F-CFT has been rendered identical to the ACE, it suffices to plainly refer to the in –depth discussions forwarded in sections 5.6.3 and 5.6.4 of this chapter.

In summary, the silent partnership feature under CFTs may be resolved by replacing the expensing feature with an interest bearing tax credit carry forward and the reinforcement of tax depreciation. The issue of tax refunds would be moot. However, the reinforcement of tax depreciation entails the reintroduction of the 'tax depreciation should correspond with economic depreciation' issue; i.e., at least to some extent – see hereunder.

Accordingly, at the end of the day, things would boil down to a trade-off between the acceptance of government being subject to private investors' risks, i.e., at least to some extent, and the (administrative) question as to how to keep tax depreciation and economic depreciation on par.

Favoring the ACE in the end

I would favor the latter, i.e., the ACE. That is also since the depreciation issues may be considered significantly mitigated under the adoption of an ACE if the matter is seen in the effects in terms of net present value – i.e., relative to the conventional corporate income tax. As discussed in the above, an accelerated tax depreciation relative to the economic depreciation would reduce not only the tax bookkeeping value of the respective asset but also the taxpayer's equity capital in respect of which the ACE is calculated against in later years. Accelerated tax depreciation reduces the ACE granted in later years (and vice versa). This offsets the tax benefits from the accelerated tax depreciation. It entails that the present values of depreciation and ACE allowances are independent of the rate against which assets are written-off in the tax bookkeeping. Furthermore, the principle of income accrual under the S-H-S concept of income would be fully appreciated. And finally, the introduction of an ACE would pose less transitional issues relative to the introduction of a modified R+F-CFT with a

[1211] – t.(1 – α) + t.(1 – α).
[1212] 0.25 * 100 = 25. Accordingly: t.[(ρ – r) + (1 – d)].
[1213] – (1 – α).
[1214] (1 – α) + (ρ – α.r) – t.(ρ – r) – t.(1 – d). Note that the formula component, now, is identical to its equivalent under the ACE.
[1215] That is, provided that d = 1.
[1216] (4,235 / 4,000) – 1 = 0,05875. Accordingly: $v_{modR+F-CFTdepreciation}$ = [(1 – α) + (ρ – α.r) – t.(ρ – r) – t.(1 – d)] / (1 – α) – 1 = (1 – t).(ρ – r) / (1 – α) – t.(1 – d) / (1 – α) + r. Note that the formula, now, is identical to its equivalent under the ACE, as v_{ACE} = (1 – t).(ρ – r) / (1 – α) – t.(1 – d) / (1 – α) + r. Hence, reinforcing the R+F-CFT with tax depreciation accordingly renders the tax identical to the ACE.

tax depreciation feature.[1217] The approach would therefore also be administratively convenient.

5.8 Final remarks

This chapter is devoted to answering the question of how to identify the taxable business proceeds for corporation tax purposes in an alternative international tax regime. What may be considered the appropriate taxable base or 'tax object' in a corporate tax 2.0?

An answer lies in the allowance for corporate equity ('ACE'). The argument is made that fairness requires nation states to tax economic rents. This may be achieved by reference to a tax base foundation concept containing an ACE, i.e., to appropriately address the financing discrimination issues that arise under the application of a typical nominal return to equity based tax system. Appreciating that it would be quite difficult to decide on the 'proper' equity allowance, one could base the tax-deduction for equity capital provided on the return on a long-term government bond, perhaps with a risk mark-up, as a proxy.

An ACE based foundation concept to tax business income produces c.q. promotes:

- equal to statutory average effective tax rates, as it taxes business cash flows;
- nil effective marginal tax rates, accordingly leaving marginal financing decisions unaffected;
- tax neutrality in the presence of timing differentials between depreciation for tax bookkeeping purposes and economic depreciation, as the present values of depreciation and ACE allowances are independent of the rate against which assets are written-off in the tax bookkeeping.

The tax cascading effects regarding equity investments in minority shareholdings could be resolved via the 'indirect tax exemption'. This economic double tax relief mechanism would operate similarly to an indirect tax credit. That is, however, with the exception that the credit available with regards to the grossed-up equity proceeds is calculated at an amount equal to the domestic tax that can be attributed to the excess earnings of the respective entity in which the equity investment is held. To efficiently arrive at a single taxation of the business cash flows involved, the economic double tax relief mechanism would need to be combined with a 'loss recapture mechanism' and a 'profit carry forward mechanism'.

The approach advocated until this point of the current analysis would however still not resolve all problems in international taxation. It would, for instance, not remove the market distortions that occur due to remaining disparities or obstacles imposed abroad. Moreover, it would not provide an answer to the investment location distortions that are caused by the inadequacies in the methodologies that are generally employed in the international tax regime to geographically divide the corporate tax base among the countries in which the multinational firm operates its business activities. Indeed, the first piece of the international tax jigsaw puzzle, taxing the firm as a single unit (Chapter 4) as well as the second piece, taxing rents instead of nominal equity return (Chapter 5) nevertheless seem to have fallen into place. This paves the way for discovering the remaining piece in the upcoming Chapter 6.

[1217] See for a comparison Michael P. Devereux et al, 'The Corporate Income Tax: International Trends and Options for Fundamental Reform', *European Commission Directorate-General for Economic and Financial Affairs Economic Paper* 2006:264, at 58.

– Chapter 6 –

In search of an allocation mechanism

Chapter 6 In search of an allocation mechanism

6.1 Introduction[1218]

The previous chapter concludes with the observation that the approach advocated up to this point would not resolve the investment location distortions that arise under the international tax regime.[1219] This study has not yet assessed the inadequacies in the methodologies that are generally employed by nation states to geographically divide the corporate tax base among the countries in which a multinational firm operates its business activities.

Indeed, when a firm operates its business activities in a cross-border environment, a methodology is required to allocate its rents to taxing jurisdictions. Please imagine, for this purpose, the 'global entrepreneur'. The global entrepreneur produces its goods and services in a multitude of taxing jurisdictions. It performs its R&D, marketing, sales, manufacturing, packaging, testing, distribution, treasury and management functions across the globe. It subsequently sells its produced goods and services within the same multitude of taxing jurisdictions.

Every tax jurisdiction in which the respective firm is active may want its share in the firm's earning power. In the previous chapters, after submitting a normative framework (Chapter 2), it has been sought to develop an equitable and neutral approach towards granting double tax relief (Chapter 3), to describe the taxable entity (Chapter 4), and to provide some suggestions for a taxable base (Chapter 5).

In this chapter, the objective is to develop a mechanism on the basis of which the multinational's rents may neutrally be attributed to taxing jurisdictions while applying the double tax relief mechanisms advocated in the previous chapters. The current chapter is devoted to developing a proper allocation key. How should the firm's taxable base be allocated geographically? Which portion of the multinational's consolidated worldwide investment returns should be geographically attributed to each of the nation states that claim entitlement to subject part of these to tax? The approach taken further builds on the notion of fairness that the international tax regime ultimately calls for a worldwide coordination of the international tax systems of nation states. This is indeed a daunting task. Yet, it seems necessary in a globalizing economy.

Taxing the multinational's rents at destination…

The analysis in this chapter is inspired by the theory of the firm and the notion addressed in Chapter 2 that the firm's business proceeds should be taxed once as close as possible to its geographic source. This implies engaging in a quest for the available approaches to pinpoint the geographic locations where the firm adds economic value. But what is the best way to determine the geographic source of the economic rents derived by the global firm?

The observation is made that income lacks geographic attributes. Income simply has no location. Income production as the result of the interplay of firm inputs and firm outputs are as global as the multinational itself. Perhaps this renders it somewhat pointless to look for the true source of income.

This, however, does not mean that there is nothing that can be said on the matter. Assessing the spectrum of possible angles ranging from the firms' input locations at their origin to the firms' output locations at their destination, the argument is made that if one only needs to agree on the allocation key, perhaps the most sensible thing to do in this respect is to aim at taking away the arbitrage opportunities as much as possible.

[1218] Occasional paragraphs in this chapter have been drawn from Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.
[1219] These arise in the presence of tax rate differentials. Under harmonized tax rates, one may also proceed to distribute tax revenues, 'revenue sharing'; see section 6.4.6.

That would lead to an attribution of tax base by reference to elements that seem rational to use but are not within the firm's control. Or, i.e., at least these elements should fall outside firm influence as much as possible. In such a case, the tax allocation would operate invariantly with respect to the location of resources.

Income is appreciated as the result of the interplays of both supply and demand, whereby the supply side of income production is under the control of the firm involved while the demand side is not – i.e., at least to a limited extent. The argument is accordingly made that it would be sensible to attribute tax base by adhering to the demand side of income production. That would produce a destination based tax base attribution approach where the tax base is assigned to the market jurisdiction, rather than the production jurisdiction as currently is the case in international taxation; a destination based sales only allocation accordingly. Notably, the assignment of rents to the destination state would not transform the corporate tax into a value added tax. Allocation revolves around the geographic assignment of tax base; it does not deal with its design.

As a connecting factor to establish tax jurisdiction, or identifying nexus, it is advocated to replace the current permanent establishment, place of incorporation and place of effective management tests for a turnover threshold test. Such a tax jurisdiction test would operate similar to the distance sales rules in European Union value added tax. Furthermore, it is argued that profit allocation by reference to separate accounting and arm's length pricing should be abolished. The tax base allocation standards advocated in this chapter would assign the tax base exclusively to the customer location. The tax base allocation mechanism would operate conceptually equivalent to a sales factor key that is common in formulary apportionment systems. The place of supply rules in European value added taxation are assessed to optimize the advocated allocation standards.

Would enhance fairness

It is argued that a destination-based tax base attribution approach would enhance fairness. That is as it would promote a global efficient and non-discriminatory allocation of firm inputs. The allocation of firm rents to the market jurisdiction would significantly mitigate the incentives to shift taxable profit by shifting corporate investment across tax borders, which exist under the current origin oriented international tax regime.

The ideal would be to adopt a destination-based tax base attribution approach on a coordinated basis, e.g., on a global scale under the umbrella of the UN, G20/OECD, or regionally, at the levels of the North American Free Trade Association and the European Union. But also if it would be impossible to attain international consensus at this point, there would still be an incentive for individual states to move towards assigning the tax base to the market state. That is because such a move would very likely boost domestic competitiveness, which would attract foreign direct investment and employment, and drive economic growth as a consequence. If one country were to decide to move to implementing a destination-based corporate tax system – particularly if the country involved would be a major producer – chances are that others would follow suit as it would be in their self-interest. As to be shown, there is a built-in incentive for this. The adoption of a destination-based tax base attribution by that first nation state may initiate a knock-on effect where the end-result could very well be a worldwide adoption by nation states of destination based corporation tax systems.

As regards the revenue effects, a transformation from an origin-based to a destination-based system may entail a redistribution of tax revenues across countries. The effects would be hard if not impossible to predict. The distributional effects would depend on various future behavioral effects, both from the perspectives of the multinationals and the taxing jurisdictions involved. What can be said though is that the question of which countries would gain and which countries would lose seems to depend on the domestic corporate sales to corporate income ratios, ceteris paribus.

6.2 'Income lacks geographical attributes'

6.2.1 *Identification of 'true geographical source of income' seems required, but theoretical rationale is non-existent*

To establish some form of profit attribution methodology, it seems to make sense to first try to establish an answer to the underlying question of how to, theoretically, identify the 'true geographical source of income'. Is there some kind of theoretical rationale available to geographically situate income which may be utilized as a base upon which some kind of profit attribution methodology could be created for tax purposes? The answer to this question, unfortunately, appears to be in the negative. I have searched and tried, and, indeed, some others have as well,[1220] but my quest to identify 'the true source of income' brought me to the conclusion that the geographical location of income is impossible to identify. Income seems to lack geographical attributes. That renders the quest for a conceptual benchmark rather pointless. It follows that the same necessarily holds true for pursuing the desire to develop an economically correct profit division method.

To my knowledge, international tax theory does not provide a paradigmatic economic foundation concept on the location of income.[1221] Available theory is of little assistance in this respect.

For instance, first, the theory of the firm is of limited help. As addressed in Chapter 4, the theory of the firm submits that, substantially, a multinational firm constitutes a single economic unit seeking to obtain economic rents on a global scale. Indeed, the theoretical rationale of the firm as a single economic unit may be of some assistance in defining the multinational group as a taxable entity for corporate tax purposes. Yet, it provides no help in discovering the geographical whereabouts of that multinational's profits.

Further, second, the income concept itself is of little help to localize its 'true' source as well. As addressed in Chapter 5, the S-H-S concept of income defines income as the sum of consumption and net change in savings over some period.[1222] The concept merely refers to some quantitative amount, a number. Its geographical location is not a property of the S-H-S income concept itself. Indeed, the concept of income perhaps provides a sound conceptual foundation for determining the amount of taxable income. Yet, as it does not refer to its location, it does not provide a stepping stone for establishing a key to geographically locate it either.[1223] Nevertheless, this does not mean that there is nothing that can be said on the matter.

[1220] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 228-246, National Tax Association, *Report of Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Business*, Proceedings of the National Tax Association 1922, 198-212, as well as Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 199-220.

[1221] Idem, and cf. Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 712-713, Reuven S. Avi-Yonah, 'Slicing the Shadow: A Proposal for Updating U.S. International Taxation', 58 *Tax Notes* 1511 (15 March 1993). This article has been republished in Reuven S. Avi-Yonah, 'Slicing the Shadow: A Proposal for Updating U.S. International Taxation', 135 *Tax Notes* 1229 (4 June 2012), at 1229-1234. In this Article, Avi-Yonah advocates a single sales factor in splitting residual profit.

[1222] Simultaneously, income can be seen as the remuneration for the provision of the production factors of labor, capital and enterprise. Economic rents may then be considered to constitute the remuneration for the provision of the last mentioned production factor, enterprise. It has also been set forth in Chapter 5 that, under the S-H-S concept of income, conceptually there is not much difference between a direct income tax and an indirect consumption tax, i.e., except for the savings component.

[1223] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 260. McIntyre submits that each taxing jurisdiction necessarily needs to accept some geographical limitations on its reach though, even if those limitations are alien to its definition of taxable income. In current international taxation, McIntyre argues, that: *"those limitations are contained in the rules defining residence jurisdiction and source jurisdiction. The proponents of combined reporting disagree with the proponents of an arm's length / source-rule system on how those rules should be specified, whether or not they agree on how income should be defined."*

6.2.2 From net value added at origin to net value added at destination

6.2.2.1 Supply side of income (firm inputs) and demand side of income (firm outputs)

In Chapter 2, I advocated the position that fairness, specifically as regards the ability to pay principle and the benefits principle, calls for income to be taxed in the nation state where the economic rents have been derived. This position reflects the notion that tax jurisdictions may tax persons on the value that they have added within these jurisdictions' geographical territories.[1224] Seen from that perspective, as said, it would make sense to seek to identify the geographical location of that value added, its 'true source', for tax allocation purposes.[1225] Accordingly, income may then be 'sourced' by reference to the location where the economic rents have been derived, assuming that it is attainable to find that place. If the sourcing of income accordingly requires the identification of the whereabouts of net value added, then the question arises as to where that is.

To discover the location of rents, one may commence with observing the supply side and demand side of income, respectively referring to firm inputs (production factors) and firm outputs (marketplace).[1226] Then, a spectrum of possibilities having two outer ends becomes available. The one end of the spectrum, making reference to firm inputs, reflects the origin of income. The outset of the other, by reference to firm outputs, reflects its destination.[1227] Essentially, both sides merit some consideration in establishing the geographical location of the respective income item.[1228] This makes the task of designing proper source rules quite a complex affair.[1229]

6.2.2.2 Supply side of income: taxing at origin

At the one end of the spectrum, taking the supply side of income into consideration, reference is made to the location of production. The supply approach directs the income items to the

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[1224] See for a comparison Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 230. See, e.g., also Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 27, referring to Musgrave: *"Musgrave defines source entitlement as "the notion that jurisdictions are entitled to tax the value added within their borders including that by non-resident factors, that is to share in the income accruing to non-resident factors and earned by them within the geographical area"."*

[1225] Cf. Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 34, who states that: *"It seems reasonable that if the apportioning mechanism is to attribute income taxing rights fairly across tax jurisdictions it does so by allocating income according to the place where income has been generated, if that place can be determined".*

[1226] The pragmatic question of identifying the economic connections between economic activities and the territories of a taxing state, i.e., the establishing of nexus, is prior the question of situs and domicile. These taxing 'principles' merely are guidelines helping assigning and assessing tax jurisdiction. See Richard M. Bird et al, 'Source vs. residence-based taxation in the European Union: the wrong question?', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 78, at 78-109.

[1227] See Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 234.

[1228] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 260 submitting that: *"an item of income arising from cross-border activities does not have a true source, if "true" source means one unambiguous geographical location."*

[1229] Cf. Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 260: *"Designing good source rules is difficult because of the many relationships, some complex, that may exist between an item of income and particular geographical areas. Many of these relationships arguably merit consideration in determining the source of the income item. Yet they cannot all be taken into account, for they sometimes conflict. For example, it is at least plausible that the source of income is the place where the revenue generated by the profit-seeking activities is obtained. So defined, the source of income is likely to be in the tax jurisdiction where goods or services are marketed. It is also plausible, however, to view the source of income as the place where the goods or services originated. That concept of source would lead to the assignment of income to the production state or states. Even if the second concept of source were accepted as the "true" source of income, the conceptual problems would continue. An origin test for source is inherently vague in many cases because the place of origin will differ depending on how far back in the chain of causality one decides to go. For example, services may be said to have their origin in the place they are performed, or in the place where the performer resides, or the place where the performer mastered the skills that allowed for the performance."*

location of the utilized production factors, essentially reflecting a concept of net value added at origin ('origin principle').[1230] Accordingly, the supply approach addresses the notion that income is located geographically where the production factors, which generate that income, are situated. Here, income represents the product, in their mutual operation, of the employed production factors, addressing the location of firm inputs, i.e., the place where the goods supplied and the services rendered originated. The identification, localization and evaluation of these factors, particularly the production factor of enterprise, would provide the stepping stones for discovering the income's geographical source. The discovery of the geographical source of the income through this means, subsequently, would identify the nation state entitled to subject the income items to tax. Viz., the localization of income within a particular state's geographical borders would make that state entitled to tax it. That state would be identified as the origin state.

The supply approach towards geographical profit attribution is generally utilized in the current international tax regime.[1231] Direct income taxes generally refer to the supply side of income. Essentially, international taxation seeks to allocate taxing rights to the origin jurisdiction. Substantially, it addresses the location where the firm employs its production factors for profit. The 'remote seller' or, perhaps, the 'new economy' 'e-tailer',[1232] for instance, is not taxed in the countries where it markets its goods. It is sought to be taxed in the production state. The location of the market is neglected for taxable profit attribution purposes. This may further be illustrated by reference to the taxation of exports of goods and services. In international taxation, these are recognized as a taxable event for corporate tax purposes. Imports of goods and services are typically left untaxed.[1233] This holds for exports of goods and services that are both external and internal to the firm; the latter consequently requires the fair value pricing for tax purposes of internal dealings and transactions.

Conceptually, the adoption of the supply approach requires an evaluation of the firm's rents – a fair value measurement of inputs – at their origin. Reference solely to costs incurred (labor costs, costs of assets used) for this purpose seems insufficient, since costs only do not explain profits.[1234] Substantially, the search aims at locating the employed income producing production factors ('nexus') and evaluating their relative contributions to the business income generation ('allocation'). Where does the global entrepreneur produce its profits? To discover the origin of income, for nexus establishment purposes, reference is essentially made to a 'functional and factual analysis', analyzing the functions performed (labor), the assets used

[1230] In this respect, I consider the concept of net value added interchangeable with economic rent, or infra-marginal return. Accordingly, the term as used here is narrower than value added as, e.g., adopted in European Union value added taxation. As regards its geographical assignment, the reference to 'at origin' basically entails the attribution of these rents to the input location of the production factor of enterprise. The using of a value added key at origin to geographically divide corporate profit has been suggested by Sven-Olof Lodin et al, *Home State Taxation - Tax Treaty Aspects* (2001), at 47-50. Also the European Commission assessed the possibility of attributing profit geographically by reference to a value added key at origin under a European Union wide corporate tax system. See Commission of the European Communities, Commission Staff Working Paper, *Company Taxation in the Internal Market*, Brussels, 23 October 2001, SEC(2001) 1681, at 414. For an extensive discussion, see Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 69-85. For analysis and critique, see Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 199-220.

[1231] Cf. Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 29, and Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 712. Devereux questions the validity in economic terms of why the location of consumption should not be taken into consideration for the purpose of establishing source. See for a comparison, further, Joan M. Weiner, 'Taxation Papers; Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *European Commission Directorate-General Taxation & Customs Union Working paper* 2005:8, at 17, making reference to Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 228-246, explaining that separate accounting assigns income to the production location.

[1232] An e-tailer is an enterprise that conducts its business online.

[1233] Although it should be said that a tax rebasing on fair value upon imports of assets has not always been made available by states, e.g., Belgium.

[1234] See James R. Hines Jr., 'Income misattribution under formula apportionment', 54 *European Economic Review* 108 (2010, No. 1), at 108-120, as well as *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Chapter VI at par. 6.27: *"there is no necessary link between costs and value."* Income is the resultant of firm inputs and firm outputs.

(capital) and risks assumed.[1235] For allocation purposes, third-party transactions are typically evaluated by reference to the agreed selling prices. The fair values of intra-firm modes of transfers, in the end, are measured by reference to often sophisticated discounted cash flow evaluations.[1236]

6.2.2.3 Demand side of income: taxing at destination

At the other outer end of the spectrum, taking the demand side of income into consideration, reference is made to the location of the market. The demand approach directs the income items to the marketplace, essentially reflecting a concept of net value added at destination ('destination principle').[1237] Accordingly, the demand approach addresses the notion that demand creates value,[1238] i.e., a customer's willingness to buy product, or put somewhat more eloquently, the presence of the firm in the hearts and minds of its customers. Accordingly, income is assigned geographically to the location where the goods and services produced are sold. Here income addresses the location of firm outputs, the marketplace where the revenues generated by the firm's commercial activities are obtained. In that alternative approach, the identification, localization and evaluation of the marketplace would provide the stepping stones for discovering the income's geographical source. The discovery of the geographical source of the income through this alternative means, subsequently, would identify which jurisdiction is entitled to subject the income items to tax. The presence of a market within a particular state's geographical borders would make that state entitled to tax. That state would be identified as the destination state.

The demand approach towards geographic profit attribution is to some extent utilized, for instance, in destination based sales-only formulary apportionment systems. Today, these are increasingly used by various US states to geographically apportion state income tax.[1239] Also

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[1235] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 22 July 2010, OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 22 July 2010 and 26 CFR 1.482-1(d)(3)(i) in conjunction with 26 CFR 1.482-1(d)(3)(iii).

[1236] The OECD sets forth that *"[v]aluation techniques can be useful tools,"* i.e., when separate accounting and the arm's length arm's standard may rationally be considered to be of little assistance; see OECD, *Revised discussion draft on transfer pricing aspects of intangibles*, 30 July 2013, OECD, Paris, 2013, at par. 163. See for a comparison *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration*s, OECD, Paris, 2010, at Chapter VI. For some illustrations on the guidance on intangible asset valuation, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, *Annex to Chapter VI*: *"Examples to Illustrate the Guidance on intangible Property and Highly Uncertain Valuation"*. See also OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Guidance on Transfer Pricing Aspects of Intangibles*, Paris, 16 September 2014, at 78 et seq.

[1237] In this respect, as said, I consider the concept of net value added interchangeable with economic rent, or infra-marginal return. As regards its geographical assignment, the reference to 'at destination' basically entails the attribution of these rents to the location of firm outputs, i.e., the firm's marketplace**.** Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, discusses the concept of value added at destination as a profit division key at 69-85. See also Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 216-217.

[1238] See Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 234.

[1239] See Carol Douglas, 'More Single-Sales-Factor States', 37 *State Tax Notes* 259 (25 July 2005), at 259-260, and Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 95. For an overview of the formulae adopted by the US States as of January 1, 2013, see David Spencer, 'Unitary taxation with combined reporting: The TP solution?', *International Tax Review*, 25 April 2013, at 2-5. See further Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 58: *"[I]f the demand approach is preferred, the* sales by destination [emphasis in the original, MdW] *factor should be given more weight."* See also William F. Fox et al, 'How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?', 53 *National Tax Journal* 139 (2005), at 139-159, Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 539, advocating a demand approach, as well as Reuven S. Avi-Yonah, 'Slicing the Shadow: A Proposal for Updating U.S. International Taxation', 58 *Tax Notes* 1511 (15 March 1993), and Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08. Destination basis taxes for companies have also been suggested by Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008). See also Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010. Michael J. McIntyre, 'The Use of Combined Reporting

indirect taxes, such as European Union value added taxation,[1240] or the US sales and use taxes,[1241] typically allocate the tax entitlement to the jurisdiction where the products are utilized or consumed.[1242] Destination-based (income) taxes, as said, substantially address the location where the entrepreneur obtains the revenues out of its profit-seeking activities. The 'remote seller' and the 'e-tailer', for instance, would be taxed solely in the countries where they market their goods.[1243] The location of production would be neglected for tax base allocation purposes.[1244] This may be further illustrated by reference to the tax-treatment of exports of goods and services. Under destination-based taxes, these are typically not recognized as taxable events and are accordingly left untaxed. Imports of goods and services typically are taxable. This generally holds true for imports of goods and services that are external to the firm. In European Union value added taxation, generally the same is true for inbound intra-firm supplies of goods.[1245]

Conceptually, the adoption of the demand approach requires an evaluation of the firm's rents at destination, a fair value measurement of firm specific outputs, i.e., the net value added at destination. Reference to gross receipts (revenues c.q. turnover) for this purpose seems insufficient, since gross receipts only do not explain profits.[1246] Substantially, the search aims at locating the marketplace ('nexus') and evaluating its relative contribution to the business income generation ('allocation'). Where does the global entrepreneur yield its rents? To discover the destination of income, for nexus establishment purposes, reference is essentially made to the location of the customer, which, for instance, is essentially the case under sales-only formulary apportionment mechanisms, European Union value added taxation, or the destination basis cash flow tax – i.e., the latter as advocated by various US and UK

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by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 249, opposes profit attribution by reference to the demand side only.

[1240] See Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax. European Union value added taxation ('EU-VAT') seeks to locate the tax at the place of final consumption. As the true place of consumption is very difficult, perhaps even impossible, to identify, EU-VAT applies place of supply rules (Council Directive 2006/112/EC; Title V; Place of taxable transactions) as a surrogate means to identifying the location where income is consumed and the country entitled to tax accordingly. For discussion and analysis, see European Commission Green Paper: *On the future of VAT: Towards a simpler, more robust and efficient VAT system,* COM(2010) 695 (2010), and Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the future of VAT: *Towards a simpler, more robust and efficient VAT system tailored to the single market*, COM(2011) 851 final, Brussels, 6 December 2011.

[1241] On the US sales and use tax system, see Neal A. Koskella, 'The Enigma of Sales Taxation Through the Use of State or Federal "Amazon" Laws: Are We Getting Anywhere?', 49 *Idaho Law Review* 121 (2012), at 124 et seq.

[1242] See for some analysis on identifying the location of profit Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 712. See for a comparison, further, Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, referring to a supply-demand approach.

[1243] A similar approach holds under the application of the distance seller rules in European Union value added taxation, see Articles 33 and 34 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

[1244] This holds although, in practice, many allocation keys are made use of which actually assign tax base to the origin state, rather than the destination state. See section 4.4.2.3.

[1245] Conceptually, intra-firm transactions should not constitute a taxable event – also in a cross-border environment. This should hold regardless of the legal organization of the firm. This notion has not been fully incorporated in European Union value added taxation ('EU-VAT'). The concept of tax grouping is common in EU-VAT (VAT Grouping). European Union Member States may allow affiliated persons to form a VAT Group, thereby creating a single taxable entity disregarding intra-firm transactions for VAT purposes. See Article 11 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added. However, unfortunately, due to the territorial restrictions provided for – only persons established in the Member State are eligible to be part of a VAT Group – intra-firm cross-border modes of transfers are generally considered a taxable event. This holds for both the intra-firm transactions undertaken by affiliated legal entities (intra-firm, inter-entity) and the supplies of goods between head offices and permanent establishments (intra-firm intra-entity). Intra-entity supplies of goods are taxable under Article 17 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax. The exception to this rule is the cross-border intra-entity provision of services. These are not taxable for VAT purposes, due to the lacking of a legal basis in the VAT directive. See Court of Justice, Case C-210/04 (*FCE Bank*). An exception however applies with regard to services provided by a *"main establishment of a company in a third country (…) to a branch of that company in a Member State and where the branch belongs to a group of persons whom it is possible to regard as a single taxable person for value added tax purposes in that Member State."* In such a case, the Court has ruled that the group in that Member State involved, *"as the purchaser of those services, becomes liable for the value added tax payable."* See Court of Justice, Case C-7/13 (*Scandia*).

[1246] See James R. Hines Jr., 'Income misattribution under formula apportionment', 54 *European Economic Review* 108 (2010, No. 1), at 108-120. Income is the resultant of firm outputs and firm inputs.

scholars.[1247] For allocation purposes, the transactions concerned are typically evaluated by reference to agreed selling prices. Please note that the demand view on the generation of income is opposite of the supply view as adopted in international taxation, which assigns taxing entitlements solely to the jurisdiction of origin.[1248] As a consequence, the demand view on profit attribution is alien to the current international tax regime.[1249]

6.2.2.4 Income as a result of interplay supply and demand

Recognition of the outer ends of supply and demand, income, rents or net value added, should indeed be considered the result of the interplay of both firm inputs and firm outputs. Goods and services do not only need to be produced, they should be sold as well. Conversely, in order to be able to sell goods and services, they need to be produced first. Income generation requires both the production (supply) and marketing (demand) components. No money is made when one of these is absent. If seen from that perspective, both the place of production and the place of the market constitute sources of income.[1250] This supply-demand view of income acknowledges that value is created through the interplay of both supply and demand.[1251] It accordingly directs the income items to the geographic locations of both production and the marketplace. It seeks to assign income geographically by addressing both its origin – the supply-side of income making reference to firm inputs – and its destination – the demand-side of income making reference to firm outputs. This view basically requires the identification, localization and evaluation of both production factors and the marketplace. These would, subsequently, provide the stepping stones for discovering the income's geographical source.[1252]

Such a supply-demand approach towards geographic profit attribution can be recognized, for instance, in the traditional formulary apportionment systems as adopted by various US states

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[1247] See Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), and Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010. Moreover, the current place of supply rules in European Union value added taxation generally seek to attribute tax base to the destination jurisdiction, referring for place of taxation purposes to the location of the customer. See Title V Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax**.**

[1248] See also Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 50.

[1249] Cf. at International Monetary Fund, *IMF Policy Paper; Spillovers in International Corporate Taxation*, International Monetary Fund, Washington, D.C., 2014, at 9. A notable exception to the rule is the location where the income 'arises'. In international taxation, dividends, interest, and royalties, as well as in certain cases fees for (technical) services rendered seem to 'arise' for tax base allocation purposes at the location of the customer and thereby the destination jurisdiction. That is, as it designates the tax base to the place of the customer's residence or the place where it carries on a business through a permanent establishment. Accordingly, these attributional rules in international tax echo those in EU-VAT.

[1250] Cf. Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 712., Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 52, and Charles E. McLure, Jr., 'Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm', 45 *National Tax Journal* 145 (1992), at 146-147. Cf. further, Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 540 and 549. See for a comparison Lawrence Lokken, 'The Sources of Income From International Use and Dispositions of Intellectual Property', 36 *Tax Law Review* 233 (1980-1981), who argues at 277-278 that the principle geographic source of proceeds from intellectual property commercialization is the property's location of use. Lokken proceeds and argues at 277 and 297 that the property is used at both the location of production ('origin') and consumption ('destination').

[1251] See Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 234. Musgrave argues that the pursuit of a supply-demand approach is a way to attain inter-nation equity.

[1252] See for a comparison Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), who advocates a supply-demand approach for intra-European Union profit allocation at 172: *"It is also my personal view that in a close-knit economic environment such as the European Internal Market, market jurisdictions should be attributed a certain share of corporate profits, because it is exactly the combination of potent markets and diversified and highly competitive industrialized regions that helps increase overall welfare in Europe. Moreover, in times when e-commerce enables producers to draw on customer bases in Member States without being physically there, market jurisdictions are in danger of losing those amounts of corporate profits that were attributed to the physical presence in the form of a subsidiary or a permanent establishment that was formerly necessary for undertaking those marketing activities (The last consideration additionally represents an argument for applying a factor presence test as the nexus standard)."*

to apportion state income tax.[1253] Also, the Canadian formulary allocation system to attribute corporate profits to the provinces and territories shows evidence of acknowledging the supply-demand view of income.[1254] These formulary systems have been utilized within these countries for the purposes of dividing the income tax base to subnational levels of government. Within the context of the European Union, a proposal from the European Commission is pending for a European Union-wide corporate tax system at the heart of which formulary apportionment is envisaged as the proper means to divide a European Union wide corporate tax base.[1255] Under traditional formulary apportionment mechanisms, the tax base is apportioned to both production and market states by means of a predetermined fixed formula reflecting both supply-side factors (payroll, assets) and demand-side factors (sales at destination).

Formulary systems typically seek to divide tax entitlements between both the origin and the destination states by attributing parts of the profit to both the jurisdictions of production and utility. The allocation keys adopted for this purpose aim at approximating the geographic location of income by reference to some apportionment factors. Typically, these factors are payroll and assets at origin to reflect the supply side of income, and sales at destination to reflect the demand-side of income.[1256] Advocates of formulary apportionment are under no illusion that formulary apportionment mechanisms do not capture the income's true source.[1257] Worth noting also is that the origin and destination factors adopted in traditional formulary apportionment echo tax allocation approaches in both origin-oriented international taxation and destination-oriented consumption taxation. This is further discussed at a later time, in section 4.4.2.2 of this chapter.

6.2.2.5 Taxing income at destination: strange?

It is noted that the geographical attribution of taxable income to the market jurisdiction may seem somewhat awkward at first. Indeed, international taxation with its practice of separate

[1253] The traditional 'Massachusetts formula' equally-weights the factors of tangible assets and rental expense, sales and other receipts, and payroll. See Article IV.9 Multistate Tax Compact. The Massachusetts formula is currently being debated within the Multistate Tax Commission. Following developments in the US states practices, it has been suggested to increase the weight on the sales factor. That is to arrive at a double-weighted revenue factor (1/4 payroll, 1/4 capital, 1/2 sales). That would put the supply and demand factors on a par. See Multistate Tax Commission, *Multistate Tax Compact Article IV - Recommended Amendments*, 3 May 2012, at 10-14, and Multistate Tax Commission, *Multistate Tax Compact Article IV Recommended Amendments As approved for Public Hearing,* December 6, 2012.

[1254] In Canada, the allocation of corporate profits to the provinces and territories takes place by reference to a two-factor formula (payroll and gross revenue). The weight put on each factor is one-half. No capital factor is used. See Sec. 402(3) Canadian Income Tax Regulations.

[1255] See Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). The European Commission has suggested a formula echoing the traditional 'Massachusetts formula', see Article 86(1) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). European Parliament proposed to increase the weight on inputs (labor: 45%, assets: 45%) and reduce the weight on outputs (sales: 10%), see European Parliament legislative resolution of 19 April 2012 on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB) (COM(2011)0121 – C7-0092/2011 – 2011/0058(CNS)), Amendments 16 and 31; changes proposed to recital 21 and 86. Parliament argues that this would be more in line with the attribution in international taxation of taxing entitlements to the country of source. The Commission cannot accept the amendment, Commission Communication on the action taken on opinions and resolutions adopted by Parliament at the April 2012 part-session, (SP(2012)388), 30 May 2012, considering an equally-weighted three factor formula the most appropriate solution. Notably, the Committee on the Internal Market and Consumer Protection proposed to take out the sales factor altogether for the factor being perceived manipulable. See Opinion of the Committee on the Internal Market and Consumer Protection for the Committee on Economic and Monetary Affairs on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB), (COM(2011)0121 – C7-0092/2011 – 2011/0058(CNS)), 25 January 2012.

[1256] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 260. McIntyre advocates an equal weighting of destination and origin factors at 249. See further Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 17, Weiner refers to Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 228-246, who argues that profits need to be divided in a manner reflecting both the supply side and the demand side of income.

[1257] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 260.

accounting and arm's length pricing geographically only attributes income to the jurisdiction of production.[1258] Yet the attribution of income solely to the supply side of income analytically is no more defensible than the attribution of income solely to the demand side.[1259] US and Canadian formulary systems have little problems with allocating tax bases to the jurisdiction of destination. Worth mentioning is the Supreme Court of South Carolina's observation in *Geoffrey* that *"the real source of Geoffrey's* [i.e., the corporate taxpayer in this case] *income is (…)South Carolina's (…) customers."*[1260] Also the CCCTB proposal should be noted at this point, since it seeks to establish the same with its destination-based sales factor. *"[D]emand is an income generating factor."*[1261] This illustrates the apparent views of tax law interpreters and designers in these countries that market states are also entitled to a piece of the pie.[1262] An increasing number of US states even assign taxable state income solely to the destination state on the basis of sales-only formulae to attract investment.[1263]

Indeed, the question of 'what to tax' (income production – Y, or income consumption – C) analytically differs from the question of 'where to tax' (origin or destination). The taxation of income and consumption is not inextricably linked with the taxation at origin and destination respectively. Just as it is analytically conceivable to design an origin-based consumption tax, it is equally conceivable to establish a destination-based income tax.[1264] If demand creates value, and therefore also constitutes a location of source,[1265] why should we not explore destination-based corporate taxes? Major consumer markets are rarely tax havens.[1266]

Although taking mutually diverging points of departure, these profit allocation systems share a similar objective: answering the question of where income has been derived geographically. The difference lies in the opposing origin and destination oriented approaches used to arrive at that location. The supply–side oriented international tax regime assesses the geographical location of income by reference to the location of production. The demand-side oriented and supply-demand-side oriented formulary systems include assessments of the sources of income by reference to the location of the marketplace. Consequently, though, as the points of departure mutually differ, the geographical profit attribution necessarily varies as well.

[1258] To introduce a destination based tax base attribution component into the international tax regime, the permanent establishment threshold, for instance, would need to be amended in such a manner that taxing entitlements would also arise when sales are made within that jurisdiction. See Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 228-246. See e.g., also Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 28. Indeed, particularly in areas where the traditional permanent establishment concept fails, e.g., in respect of e-commerce, scholars have advocated such an approach. See Walter Hellerstein, 'State Taxation of Electronic Commerce', 52 *Tax Law Review* 425 (1996-1997), at 497-499, and Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 510. See also Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000), referring to Hellerstein, at 1671. Both authors suggest in this respect to attribute taxing rights to taxing jurisdictions by reference to a quantitative concept designed as a sales at destination threshold test. To establish nexus for proceeds from electronic commerce, they suggest a *de minimis* amount of gross income earned within the taxing jurisdiction. To establish the place of taxation, both commentators refer to the billing address of the customer.

[1259] See Benjamin F. Miller, 'Worldwide Unitary Combination: The California Practice', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination*(1984) 132, at 135.

[1260] See Supreme Court of South Carolina, *Geoffrey Inc. v. South Carolina Tax Commission,* 437 S.E. 2d 13 (1993).

[1261] See Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 12 (par. 46).

[1262] Cf. Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 272.

[1263] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 249, and Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 208.

[1264] Cf. Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 539. Destination basis corporation taxes have been suggested by various scholars. See for instance, Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008). See also Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010, and Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08.

[1265] Contra, Christoph Spengel et al, 'The Impact of ICT on Profit Allocation within Multinational Groups: Arm's Length Pricing or Formula Apportionment?', *ZEW Discussion Paper* 2003:53, at 6, who question whether demand constitutes a source of income, and subsequently whether income should be attributed to the market jurisdiction.

[1266] The substantial costs involved of operating consumer markets require substantive revenues to finance them. Cf. Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 539.

6.2.3 *Nothing sensible to say on geographical location of income, but agreement necessary*

6.2.3.1 *Locating income; no conceptual benchmark available for rule-making*

The identification of the different approaches, however, has not yet answered the question as to which of these approaches – origin, destination or a combination thereof – should be preferred over the other. To answer that question it needs to be assailable to discover the true source of income normatively directing that preference.

Only if there is some fundamental underlying rationale or normative benchmark available to base upon such a preference, one may be able to theoretically favor one approach over the other. And, indeed, if such a benchmark proves to be non-existent, there is not much more to say, normatively that is, on these diverging supply-side and demand-side approaches towards geographically locating income than that they mutually differ. As a consequence, the same necessarily holds true for the different mechanisms conceivable on the basis thereof to distribute corporate profits across countries. If any notion on the true geographical location of income is absent, while various profit attribution mechanisms are simultaneously conceivable, it necessarily cannot be decided which one is 'better' than the other. So, normatively, comparing supply-side transfer pricing approaches for this purpose to, for instance, supply-demand-side or even demand-side formulary approaches as the case may be, seems somewhat senseless. Transfer pricing is not better than formulary apportionment or vice versa, i.e., in the case where an underlying benchmark rationale for the purpose of conceptually locating income geographically cannot be identified.[1267]

It may be acknowledged that neither firm inputs nor firm outputs are solely responsible for wealth creation. Economic rents, as said, are the result of the interplay of firm inputs and outputs. Yet, by viewing economic rents in such a way, the single conclusion available is that profit is a number rather than a geographic location. In addition, if value has its inextricable roots in both supply side and demand side factors, what is the use of trying to separate them for geographical profit attribution purposes? Quite little it seems.[1268] Moreover, in today's

[1267] See Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 29, who submits that this understanding makes it possible to value the various, often opposite, views on profit attribution mechanisms as what they truly are: *"the result of choosing different premises at the outset without explicitly identifying diverging starting points."* Advocates of transfer pricing sometimes argue that formulary approaches are a worse alternative to transfer pricing, as predetermined formulae do not capture the income's true geographical source. See, for a comparison, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Chapter I, at par. 1.16-1.18. It needs to be said, however, that if income lacks geographical attributes, the same equally holds for transfer pricing. Note Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 253: *"The apparent logic of the critics of formulary apportionment is that the designers of a formulary apportionment system must have assumed that income is always earned proportional to the apportionment factors because that result is the anticipated one under formulary apportionment. By that faulty logic, the designers of an arm's-length/separate-accounting system can be accused of assuming that MNEs earn much of their income in tax havens."* Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 29, proceeds to submitting that the matter boils down to the acknowledging that formulary approaches and profit attribution methodologies in international taxation (separate accounting and arm's length pricing) do not aim at achieving the same ideals, as the former rests on supply-demand views on income, while the latter rests on supply views of income. Mayer further refers to Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 237-240, explicitly stating that formulary approaches including a sales factor accordingly is not suitable to replicate the profit allocation results under current international tax standards.

[1268] Cf. Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 32, who argue that any attempts to separate supply and demand factors for this purpose is as futile as trying to determine which blade of scissors does the cutting. The metaphor used e seems to allude to a quote by Alfred Marshall, *Principles of Economics: An Introductory Volume 8th edition* (1938), at 348 (Book V, Chapter III, § 7): *"We might as reasonably dispute whether it is the upper or the under blade of a pair of scissors that cuts a piece of paper, as whether value is governed by utility or cost of production"*, thereby, accordingly making reference respectively to the interplay of demand and supply towards value creation. Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 234, makes use of this metaphor also: *"The first is a supply approach which says that income has its source where the factor services which generate that income operate, a concept of value added at origin. The second is a supply-*

integrated global marketplace dominated by multinationals, firms derive their rents globally rather than locally. The economic reality of multinationals, global entrepreneurs, to whom the tax attribution methodology is intended to be applied is that their interdependent and integrated business operations are conducted in a variety of taxing jurisdictions. All of these operations combined fundamentally contribute to the multinational's profit-making.[1269] Firm rents, indeed, typically are firm specific rather than location specific.[1270] Both firm inputs and firm outputs are global, as is the multinational itself.

As this holds true, economics does not offer any rationale for preferring origin over destination. Many argue that this, indeed, is the case.[1271] As said, the business profits and rents generated by a multinational are the outcome of an entangled and integrated complex of cross-border internalized and interdependent business processes, which cannot be unbundled, segregated and individually appraised in any meaningful way. The economic activities of the various operations undertaken within the group by the various group companies contribute to the multinational profit making *"in an essential but indeterminate manner"*.[1272] This makes it conceptually and therefore also pragmatically impossible to establish the contributions of individual business operations, or those of individual multinational group members.[1273]

This necessarily entails that if these factors cannot be segregated meaningfully, they *a fortiori* also cannot be subsequently located and quantified geographically in any meaningful way.[1274] If the contributions to profits cannot be isolated per business unit or multinational group entity, they cannot, seen in isolation, be geographically attributed either. In that event, the conclusion is that business income lacks geographical attributes.[1275] *"[I]t is generally logically impossible*

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demand approach which holds that market value is created through the interplay of supply and demand, by both blades of the Marshallian Scissors." Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 27-28, refers to this also.

[1269] See Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 104.

[1270] See also Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008).

[1271] See Peggy B. Musgrave, 'Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union, Issues and Options for Reform* (2000) 46, at 59: *"There does not appear to be any objective, single answer to the question of how company profits should be divided in a multijurisdictional setting."* Both Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 17, and Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 27-28, refer to Musgrave. Mayer on Musgrave: *"She puts forward that there are two basic understandings of source* [i.e., the supply side and supply-demand side understanding of source, MdW] *that would meet this definition, and that economics does not offer a rationale for preferring either one over the other."*

[1272] See Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 104.

[1273] Cf. Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 7 and 34.

[1274] See Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, who submitted at 234 that: *"…there is no fundamental economic rationale for preferring from the outset one of those concepts* [i.e., the supply approach and supply-demand approach, MdW] *over the other."* Musgrave preferred the supply-demand approach, as, e.g., adopted in traditional US state income tax apportionment formulas (e.g., the equally weighted three factor Massachusetts formula) utilizing both supply side (capital and labor) and demand side (sales at destination) formulae to geographically attribute corporate profits to US states. Worth noting is that also the CCCTB working group sees room for the inclusion of a sales at destination key to attribute corporate profits interjurisdictionally. See e.g. Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 56, *Report and overview of the main issues that emerged during the discussion on the sharing mechanism SG6 second meeting – 11 June 2007*, Taxud E1 OP, CCCTB\WP\056\doc\en, Brussels, 20 August 2007, at 9 (par. 31), Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 12 et seq (paras. 43 et seq.). However, as Musgrave mentions, none of the available approaches, from their outsets, can cogently rule out any of the others. See also Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 172.

[1275] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 253. See Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 104.

to tax accurately the corporate profits originating in any particular state of a multistate firm."[1276]

And, accordingly, in the end, neither origin approaches, nor destination approaches, nor any of their combinations provide any guidance in the design of a theoretically sound cross-border profit attribution key. Indeed, then, the quest for the 'true' geographical source of income for taxable profit allocation purposes, by segregating and allocating the contributions to corporate profits of the various business operations dispersed across a multitude of taxing jurisdictions, perhaps results into a *"pointless task of localizing the non-localizable"*.[1277]

This being said necessarily also entails that whichever kind of profit attribution methodology a country utilizes, i.e., whether it uses source rules for this purposes or apportionment formulae, it is employing some proxy to assign a location to taxable income items. As income lacks geographical attributes, there is no single methodology that may fairly claim to localize the 'true' geographical source of income. Viz., income has no single source and the true source of income does not seem to exist. This would also mean that the rules and methods adopted in taxation to assign taxable income geographically are *"legal rules, not economic rules"*.[1278]

As income has no true geographic source, transfer pricing and formulary apportionment may both be considered to operate arbitrarily.[1279] In the end, both use some proxy to attribute profit geographically. Neither discover the income's 'true' source.[1280] Indeed, income has no location; this holds true regarding *any* procedure to geographically divide multinational profits.[1281]

6.2.3.2 "Slicing the shadow": agreement seems required, but on what?

So, if income cannot be truly located, if economics does not provide a benchmark here, and if the currently employed rules lack theoretical support as a result of this, how do we decide on a profit attribution methodology for tax purposes? What should the proxy look like? How should we 'slice a shadow'?[1282] In the end, as there is not much to say about the 'right' profit allocation system utilized, things boil down to a matter of judgment.[1283] This, however, does not mean that nothing can be said on the matter.

[1276] See Charles E. McLure, Jr., 'The State Corporate Income Tax: Lambs in Wolves' Clothing', in Henry J. Aaron et al (eds.), *The Economics of Taxation* (1980) 327, at 343.

[1277] See Stanley I. Langbein, 'The Unitary Method and the Myth of Arm's Length', 30 *Tax Notes* 625 (17 February 1986), at 670. See also Lawrence Lokken, 'The Sources of Income From International Use and Dispositions of Intellectual Property', 36 *Tax Law Review* 233 (1980-1981), who argues at 244 that there is no objective method for dividing a gain on sale of intellectual property between the production and selling functions.

[1278] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 262. McIntyre further argues at 267 that, because of this: *"the rules used for assigning income to a particular geographical place (…) should be judged not by some absolute standard or by some principles of economics but by the contribution they make to the goals of the tax system of which they are a part"*. Worth noting Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1 GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 9 (par. 20): *"The brief description of the three factors has shown that – in reality – there are not 'ideal' solutions and the choice concerning the definition, valuation and location of the factors and the inclusion (and their weighting) in the formula requires a great deal of work."*

[1279] Cf. Charles E. McLure, Jr., 'The State Corporate Income Tax: Lambs in Wolves' Clothing', in Henry J. Aaron et al (eds.), *The Economics of Taxation* (1980) 327, at 343.

[1280] Cf. Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 262.

[1281] Cf. Richard M. Bird et al, 'Source vs. residence-based taxation in the European Union: the wrong question?', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 78, at 91.

[1282] The reference to 'slicing the Shadow' at this place and in the header alludes freely to a remark of Justice Brennan of the US Supreme Court in *Container Corp. v. Franchise Tax Board*, 463 US 159, at 192; 103 S. Ct. 2933, at 2954 (1983), submitting that allocation *"bears some resemblance . . . to slicing a shadow"*). See also Reuven S. Avi-Yonah, 'Slicing the Shadow: A Proposal for Updating U.S. International Taxation', 58 *Tax Notes* 1511 (15 March 1993), and Steve Christensen, 'Formulary Apportionment: More Simple – On Balance Better', 28 *Law and Policy in International Business* 1133 (1996-1997), at 1133.

[1283] See Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 33; at 46: *"The choice of factors and their weighting cannot really be founded on principled scientific methodology, but they should ultimately reflect the political*

In Chapter 2, it has been argued that business proceeds should be taxed only once. To tackle disparities or 'mismatches', this calls for a harmonized approach to taxable income allocation.[1284] Viz., differentials in tax base allocation entail double (non-)taxation issues triggering overtaxation and undertaxation, as well as arbitrage opportunities. Further, I submitted that the international tax regime should operate as neutrally as possible as regards to the distribution of production factors, i.e., tax neutrality towards investment location decisions. In addition, the profit attribution regime should not be easily manipulated and, accordingly, should provide for steady tax revenues to finance public expenditure, also with respect to multinational income. However, since there is no such thing as a theoretically correct distribution of profits key, there is not much principled to say about the way income should geographically be divided to countries.[1285]

And if one only needs to agree on the allocation key, perhaps, the most sensible thing to do in this respect is to aim at taking away arbitrage opportunities by attributing tax bases by reference to elements that seem rational to use but are not within the firm's control. Or, at least these elements should fall outside firm influence as much as possible.[1286] Accordingly, in such a case that the tax allocation would operate invariantly with respect to the allocation of resources.[1287] This may be considered a rational approach, especially, since globalization and internationalization, the emergence of intangibles and e-commerce, has not made it easier to identify the income's geographical source under the current supply-side international tax regime.[1288] The increasing mobility of production factors, particularly intangible and monetary capital, renders effective taxation by nation states an increasingly complex affair. This reality puts pressure on nation states seeking tax revenues to finance their public expenditures.

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preferences as to the purpose of corporate taxation (whether it should remunerate producing or marketing states)." See Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 30: *"Relative factor weights would then be left to be decided as a part of the agreed fundamental entitlement rationale, which is not determined by economic considerations. (…) [I]f the supply-demand approach is pursued, the inclusion and relative weighting of apportionment factors is completely undetermined by economic criteria"* . See also Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, describing things at 237 as *"a matter of consensual judgment"*, as well as National Tax Association, *Report of Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Business*, Proceedings of the National Tax Association 1922, 198-212, at 202, stating that *"there is no one right rule for apportionments"* and that *"All methods of apportionment … are arbitrary-the cutting of the Gordian knot…"*. Note Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), 199-220, who concur with these NTA considerations at 210.

[1284] E.g. Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). See also European Commission, Staff working paper, The internal market: factual examples of double non-taxation cases, Consultation document, Brussels, TAXUD D1 D(2012), as well as Commission of the European Communities, Commission Staff Working Paper, *Company Taxation in the Internal Market*, Brussels, 23 October 2001, SEC(2001) 1681. The OECD advocates taking a harmonized approach as well, see e.g. OECD, *Addressing Base Erosion and Profit Shifting, OECD Publishing, 12 February 2013, and* OECD*, Hybrid mismatch arrangements; Tax policy and compliance issues*, OECD, Paris, 2012 where a coordinated approach is advocated to tackle mismatches. See for a comparison National Tax Association, *Report of Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Business*, Proceedings of the National Tax Association, Washington, D.C., 1922, 198-212, at 202: *"[T]he only right rule … is a rule on which the several states can and will get together as a matter of comity"*, and Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 46: *"The only correct rule might simply be the one on which Member States can agree."*

[1285] Notably, if income allocation is a judgment call, one may also plea to uphold SA/ALS. Why get rid of an allocation mechanism that has been in place for over a century for something else? Something which has been untried in practice at the international level and is necessarily unable to geographically locate true profit as well? See for a comparison, Jeffrey Owens, 'Income Allocation in the 21st Century: the End of Transfer Pricing?' Should the Arm's Length Principle Retire?', 12 *International Transfer Pricing Journal* 99 (2005), at 99. Owens argues that we should be very cautious about replacing a well-established institutional face with an untried visage. Rather, Owens argues, our efforts should continue to focus on making the existing systems work more effectively.

[1286] Cf. Charles E. McLure, Jr, 'Comments on Musgrave', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 264, at 251.

[1287] Cf. Charles E. McLure, Jr., 'The State Corporate Income Tax: Lambs in Wolves' Clothing', in Henry J. Aaron et al (eds.), *The Economics of Taxation* (1980) 327, at 345.

[1288] See e.g., International Monetary Fund, *IMF Policy Paper; Spillovers in International Corporate Taxation*, International Monetary Fund, Washington, D.C., 2014, at 48-50, and OECD, *Addressing Base Erosion and Profit Shifting, OECD Publishing, 12 February 2013, at 35-36.*

Obviously, this is a serious matter.[1289] It should not be forgotten that it is the tax revenues through which states finance their public goods. If states encounter structural and perhaps even insurmountable difficulties in raising revenue in the long run, it will be equally impossible to uphold the welfare state.[1290]

The international tax regime, as said, seeks to allocate corporate profit to the country of origin. However, it increasingly faces difficulties in this respect. Empirical evidence suggests that in the presence of tax rate differentials, the supply-side international tax systems of countries produce incentives for the shifting of corporate profits, both paper profits and real profits, to low taxing jurisdictions.[1291] That is, the tax responsiveness of real activity is less apparent, though.[1292] Perhaps the reason for this, besides the difficulties in obtaining relevant data on the subject,[1293] is that the incidence of corporate tax cannot be identified. As it is unknown who ultimately bears the tax (the worker, the supplier, the customer, the consumer, or the owner), it is very hard to assess the responses of tax rate differentials on the (re)location of firm inputs and outputs. For some economic analysis, see section 4.5.1 of this chapter.

In the upcoming section, the current regime is further assessed to identify the reasons why the arbitrage arises. Why does the current separate accounting / transfer pricing system fail? Is it worthwhile to explore the spectrum somewhat further and look into some of the more destination based alternatives available to geographically attribute corporate rents?

6.3 Tax pie sharing under the supply side profit attribution system in International taxation: why it fails

6.3.1 Current international tax system aims at locating and evaluating firm inputs, but falls short

Today's international tax regime system seeks to identify the true source of income.[1294] Its purpose is to allocate taxing entitlements to the country of origin by locating and evaluating business income by reference to firm inputs. That is, it essentially seeks to localize and evaluate the production factors employed. Where does the global entrepreneur produce its rents? For this purpose, the international tax regime has established a taxable presence concept ('nexus') and a methodology to subsequently evaluate that taxable presence

[1289] Cf. Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 698.
[1290] Cf. Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000), at 1573-1676. See for a comparison, International Monetary Fund, *IMF Policy Paper; Spillovers in International Corporate Taxation*, International Monetary Fund, Washington, D.C., 2014.
[1291] See International Monetary Fund, *IMF Policy Paper; Spillovers in International Corporate Taxation*, International Monetary Fund, Washington, D.C., 2014, at 12-13, Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines A Proposal for Reconciliation', 2 *World Tax Journal* 3 (2010), at 6, and Reuven S. Avi-Yonah et al, 'Formulary Apportionment – Myths and Prospects; Promoting Better International Tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative', 3 *World Tax Journal* 371 (2011), at 393, as well as Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 9. For some empirical support for arguing the responsiveness of real economic activity to tax rate differences the authors refer to Ruud de Mooij et al, 'Taxation and Foreign Direct Investment: A Synthesis of Empirical Research', 10 *International Tax and Public Finance* 673 (2003), at 673-693, as well as Ruud de Mooij, 'Will corporate income taxation survive?', 3 *De Economist* 153 (2005), at 277-301, See further Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 7 and OECD, *Addressing Base Erosion and Profit Shifting, OECD Publishing, 12 February 2013, at Chapter 2; also* for literature references.
[1292] See Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 10.
[1293] See OECD, OECD Committee on Fiscal Affairs, *Request for input BEPS ACTION 11: Establish methodologies to collect and analyse data on BEPS and the actions to address it, 4 August 2014 – 19 September 2014*, OECD Publishing, Paris, 4 August 2014.
[1294] Cf. Charles E. Mclure, Jr., 'Corporate Tax Harmonization in the European Union: The Commission's Proposals', 36 *Tax Notes International* 45 (4 October 2004), at 48.

('allocation'). Basically, all nation states worldwide utilize the same approach to some extent for this purpose.[1295]

If it is assumed that the supply side of income provides a proper conceptual foundation to build a cross-border profit attribution mechanism, the question arises as to whether the instruments that are currently used in international taxation are sufficiently equipped to serve their purpose. Do they work or do they fail?

Unfortunately, it seems that is is the latter. In a global market the current system seems destined to fail. The system provides for some concepts that are completely outdated. In respect to some others, an economic rationale even is completely absent. Countries typically respond by introducing halfway anti-avoidance rules countering symptoms rather than the underlying causes of the arbitrage created.[1296] However, if the proper tool is chosen out of the available alternatives, nexus at origin perhaps may be sufficiently established. In the end, only the 'significant people functions' developed by the OECD to localize income merit some consideration to base upon some kind of nexus concept for this purpose.[1297] However, unfortunately, current international tax law does not seem to provide for any sufficient means to subsequently evaluate that taxable presence at origin. Even if the best-suited transfer pricing method is employed for this purpose, the profit split method, firm inputs cannot be evaluated objectively at the end of the day. On balance, the location of production, is therefore impossible to evaluate, rendering it conceptually and pragmatically unfeasible to allocate net value creation at origin. Corporate rents just cannot be properly sourced at origin.

6.3.2 Current international tax system fosters profit shifting as a consequence

The consequence of this, unfortunately, is that the current international tax system, in its presence of tax rate differentials, fosters the shifting of profit to low-taxing jurisdictions.[1298] Due to its poor design, the system facilitates the shifting of paper profits. Various features of the current system completely lack economic rationales, providing various tools for the international business community to be used to influence the taxable profit attribution and their AETRs accordingly without substantially altering corporate investment.[1299] In addition, in the current presence of tax rate differentials, real investment location decisions are being distorted as well, ceteris paribus, having the consequence of providing incentives to locate investment and subsequent returns – real profits – to tax jurisdictions subjecting corporate profit to comparatively lower AETRs. *"The basic idea is that a firm that is able to choose between two profitable location decisions would decide to locate production where post-tax*

[1295] See OECD, *Addressing Base Erosion and Profit Shifting, OECD Publishing, 12 February 2013, at Chapters 1, 4 and 5.*

[1296] See for a comparison Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 271: *"Because of weaknesses in the residence rules, source rules, and transfer-pricing rules, and the flexible nature of accounting rules, many countries have adopted anti-avoidance rules to limit abuses arising under the arm's-length/source-rule methodology."*

[1297] To discover the origin of income, for nexus establishment purposes, reference is essentially made to a 'functional and factual analysis', analyzing the functions performed (labor), the assets used (capital) and risks assumed. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, and 26 CFR 1.482-1(d)(3)(i) in conjunction with 26 CFR 1.482-1(d)(3)(iii).

[1298] See for instance Charles E. McLure, Jr., 'The State Corporate Income Tax: Lambs in Wolves' Clothing', in Henry J. Aaron et al (eds.), *The Economics of Taxation* (1980) 327, at 343: *"… the locational allocation of resources is distorted by differentials in the corporate profits taxes levied in various states."*

[1299] Obviously, the flawed international tax law 'toolkit' may be used by well-advised MNEs to optimize their tax costs. This is often seen as wrongful corporate behavior, encroaching upon subjective beliefs on good corporate governance. In my view, however, as corporate tax equals corporate cost, which from a business economics perspective should be minimized, there is not much 'wrong' with tax planning. States levy tax. In the event that the public feels that MNEs do not pay their 'fair share', in my view, it is the obligation of the states involved to design a properly functioning international tax system. If they do not, causing tax planning and avoidance (opportunities) as a result of this, this matter is not for the MNEs to resolve. If the public feels that corporations should pay a 'fair share' of corporate tax which the public feels that they do not, in my view, one should proceed to criticize the tax law drafters for designing poor tax rules that facilitate profit shifting rather than referring to some subjective popular beliefs on corporate responsibilities to pay fair shares of corporate tax. The levying of corporate tax is the responsibility of the state, not that of a multinational. Fair share accordingly is not a corporate responsibility, it is the primary responsibility of the nation state.

net present value is the higher, i.e., the country where the AETR is the relatively lower."[1300] Accordingly, the current regime not only promotes the shifting of paper profits, it fosters real profit shifting as well. That is, although the tax responsiveness to real activity, as said, seems less apparent than the tax responsiveness to locating 'paper' investments.[1301] Perhaps that, in view of the presence of paper-profit shifting opportunities, there is little need to engage into real profit shifting.

Moreover, multinationals may often be able to credibly threaten the origin state to relocate and invest elsewhere. Consequently, countries seeking to attract foreign investment or to preserve domestic investment as often may have no choice but to compete with each other for investment by lowering their AETRs under the global average: tax competition. This, in reality, occurs, either through reductions of general corporate tax burdens, i.e., the 'race to the bottom' hypothesis,[1302] or via the reduction of effective tax burdens relating to certain economic activities. These activities may involve both portfolio investment and direct investment activities. The measures involving portfolio investments typically revolves around the incentivizing of sheltering portfolio investment proceeds and proceeds from intra-group financing arrangements. The incentives that such tax havens provide to the 'IP HoldCos' or 'shell companies' of multinationals are generally referred to as 'IP-holding regimes', or 'headquarters regimes'. The measures involving direct investments typically involve granting incentives to attract investment in intellectual property, transportation, or production. The incentives that such 'production tax havens' provide to such mobile direct investment activities are sometimes referred to as 'tax holidays', i.e., where these relate to certain types of direct investment proceeds.[1303] 'Tax free zones' or 'low-taxed economic zones' may be put in place where the countries involved seek to attract direct investments to certain pre-designated areas within their territories.[1304] The awarding of such tax incentives to attract investment triggers (harmful) tax competition and (illegal) fiscal state aid issues – the latter where European Union law applies.[1305]

So why is that? What causes the international tax system to be broken? To answer that question, some further elaboration on the current nexus standards and allocation standards is called for.

[1300] See Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 716. See also James R. Hines, Jr., 'Lessons from Behaviorial Responses to International Taxation', 52 *National Tax Journal* 305 (1999), at 308-319.

[1301] See for some analysis and literature references Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38. Intuitively, the explanation for this may be that to the extent it may be possible to shift paper profits by engaging into intra-firm tax planning arrangements and obtain a tax saving accordingly there is no need to shift taxable profits by relocating real investment. Why shift real investment if the tax saving could also be made available through less burdensome means, i.e., through 'box and arrow tax planning'? As it seems easier to shift paper profits than real profits, it has been argued in the literature that tax planning opportunities and the presence of tax havens may even be considered economic efficient. That is, since the planning opportunities in the international corporate tax systems, i.e., the availability to structure ones way around ones moral obligation to contribute to society, would accordingly render investment location decisions less responsive to corporate taxation. See Qing Hong et al, 'In praise of tax havens: International tax planning and foreign direct investment', 54 *European Economic Review* 82 (2010, No. 1), at 82-95. Such an approach seems to imply corporate tax to constitute a pure economic cost – and with that it equivalently seems to imply that the abolishment of business income taxation would promote economic efficiency. In my view, such an approach disregards the notion of taxation as a means to finance public expenditure, i.e., something from which society as a whole benefits from, firms included.

[1302] See for a comparison Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 7.

[1303] See on such tax incentives the recent OECD briefs to G20: *Part 1 of a Report to G20 Development Working Group on the impact of BEPS in Low Income Countries*, OECD, Paris, July 2014, and *Part 2 of a Report to G20 Development Working Group on the impact of BEPS in Low Income Countries*, OECD, Paris, August 2014.

[1304] See Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000), at 1588, and International Monetary Fund, *IMF Policy Paper; Spillovers in International Corporate Taxation*, International Monetary Fund, Washington, D.C., 2014, at 7 on the pervasiveness of tax incentives undermining revenue in developing countries.

[1305] For some further elaboration, see Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

6.3.3 Nexus in international taxation; why only 'significant people functions' has some appeal to locate income at origin

6.3.3.1 Nexus required to establish taxable presence, but instruments are often arbitrary

The process of geographically allocating multinational business income requires two steps to be taken. First, the business activities that a firm undertakes within a particular taxing jurisdiction need to exceed a certain minimum threshold: *nexus*. Nexus refers to the location of income ('where?'). To the extent that the chosen threshold test has been met and a taxable connection with the respective taxing jurisdiction has been established, subsequently, second, the business income derived by the taxpayer, or a part thereof, needs to be attributed to that respective taxing jurisdiction: *allocation*. Allocation refers to the evaluation of the located income ('how much?').

Various instruments have been adopted in international tax to identify nexus. The question as to which one applies in a particular scenario depends on various (legal) facts and circumstances. Yet, some of the instruments chosen for this purpose have, at best, become outdated, e.g., the 'permanent establishment' concept. More often the expressions of nexus that are used in international taxation completely lack economic rationale, such as the company's 'place of incorporation'. Arbitrage, paper profit shifting opportunities, investment location distortions, and decreased corporate tax revenues are the inevitable consequence of this. Let us further scrutinize matters.

6.3.3.2 Broken nexus concepts: corporate nationality, corporate residence, and the permanent establishment threshold

6.3.3.2.1 Broken nexus concepts in international tax law

All nexus concepts utilized in international taxation set a qualitative threshold standard referring to legal and physical-geographical connecting factors. The problem, however, first, is that legal realities do not always correspond with economic realities. Typically, only the legalities agreed upon by third parties are driven by market forces.[1306] Intra-firm legal realities are not. Second, the same has also become true regarding the physical-geographical brick and mortar realities currently required to establish taxable presence, for instance under the permanent establishment threshold. Also these no longer necessarily correspond with economic reality. The digitization of the economy, for instance, has made the requirement to establish a physical presence within a country to service its market rather insignificant.[1307] Perhaps, in the end, only the presence of people, the firm's workers operating their employment contracts, the production factor of labor that is, may be of some help in providing a proxy to localize income at its origin.

[1306] See for a comparison Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 177: *"Profit shifting between two entities mainly takes place when they are under common control, whereas below that level external shareholders can be expected to oppose measures that artificially reduce one company's profits or increase its tax burden."* See also Benjamin F. Miller, 'None Are So Blind as Those Who Will Not See', 66 *Tax Notes* 1023 (13 February 1995), at 1030: *"For entities that are 50-percent-or-less owned, a self-policing mechanism exists in the form of the other shareholders."*

[1307] See e.g. Lee A. Sheppard, 'The Digital Economy and Permanent Establishment', 70 *Tax Notes International* 297 (22 April 2013), Charles McLure, Jr., 'Alternatives to the concept of permanent establishment', 1 *CESifo Forum* 10 (2000), at 10-16, Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006), at 266-279, as well as Tatiana Falcão et al, 'Assessing the Tax Challenges of the Digital Economy: An Eye-Opening Case Study', 42 *Intertax* 317 (2014), at 317-324, and Manoj Kumar Singh, 'Taxing E-Commerce on the Basis of Permanent Establishment: Critical Evaluation', 42 *Intertax* 325 (2014), at 325-333. See on the matter also OECD, OECD Committee on Fiscal Affairs, *Public Discussion Draft BEPS Action 1: Address the tax challenges of the digital economy, 24 March – 14 April 2014*, OECD Publishing, Paris, 24 March 2014, and OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Addressing the tax challenges of the digital economy*, OECD Publishing, Paris, 16 September 2014.

6.3.3.2.2 The sheer meaninglessness of corporate nationality (incorporation seat system)

References for nexus establishment purposes to legalities may be recognized in the international tax principle of (corporate) nationality, i.e., the 'nationality principle'. Corporate nationality is used by many countries, e.g., the United States, Switzerland, and the Netherlands, to determine a company's place of residence for tax purposes and with that its unlimited liability to corporate tax.[1308] Corporate nationality constitutes a subjective, *ad personam*, taxing principle, established by reference to the statutory seat of a corporation, or the domestic laws of the state on the basis of which it was incorporated (i.e., the so-called 'incorporation seat system').

Where nexus is established accordingly, a legal formality decides on the location of corporate income. Typically, the use of the nationality principle entails a worldwide tax liability, recognizing the taxpayer's worldwide income for tax calculation purposes. Indeed, the state claiming tax entitlement on the basis of the nationality principle subsequently steps down to provide double tax relief to secure single taxation in respect of the taxable entity's foreign source income.[1309] However, the residual of the corporation's profits derived is located for tax purposes in the country of the corporation's nationality.

Indeed, such an approach is administratively convenient. It however operates quite arbitrarily. The place of incorporation generally is a historic fact, which, as a rule, cannot be changed formally.[1310] However, being neatly assisted for tax purposes by the 'as made-available' separate entity approach – or corporate veil – a multinational may deploy the concept of corporate nationality for its benefit by setting up a new company in (or, if legally available, merging or converting it into)[1311] a jurisdiction wherever it desires to, and, accordingly have the (residual) profits of the investments undertaken through that company being allocated to that jurisdiction as a result of this.[1312] The multinational may accordingly establish an additional tier to its multi-nationality.[1313]

A formal-legal criterion such as corporate nationality, however, constitutes a completely meaningless concept to establish nexus for profit allocation purposes. That is, it lacks economic basis. Corporate nationalities have very little to do with income production. Furthermore, the globalization of markets drives corporate law systems of states to a certain degree of congruency, for instance regarding the entity's legal personality, its limited legal liability and the tradability of shareholders' interests. In the end, for instance, there is not too much difference between a US Corp., a UK Ltd., a Dutch BV, a Luxembourg SARL, a Belgian BVBA, or a Swiss AG in this respect. Via this means, multinationals basically have a broad palette of substantially interchangeable legal forms at their disposal through which they may legally organize their business affairs. Any of such decisions leaves the conduct of actual business operations virtually unaffected. This reality renders the nationality of a legal form substantially meaningless as a tool to establish a taxable corporate presence.

[1308] See for instance, Article 2(4) Dutch Corporate Income Tax Act 1969. In the Netherlands, companies incorporated under Dutch law, – Dutch corporate nationals – their Dutch nationality is used to deem these entities' corporate tax place of residence in the Netherlands. Under Dutch corporate income tax law, a company's place of residence is generally determined by reference to its place of effective management.

[1309] See Article 5 OECD Model Tax Convention in conjunction with Article 7 OECD Model Tax Convention.

[1310] Notably, within the European Union the Court of Justice has made intra-European Union cross-border transfers of real seats of corporations possible, also in respect of entities formed under incorporation seat civil law systems. See Court of Justice, Cases C-378/10 (*VALE*) and C-210/06 (*Cartesio*).

[1311] Within the European Union, corporate nationalities of companies themselves are mobile as well since corporate European Union law allows for cross-border mergers of limited liability companies, making it possible, for instance for a Dutch limited liability company to merge into a Luxembourg limited liability company, accordingly obtaining Luxembourg nationality and the accompanying allocation of its residual profit to Luxembourg. See Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies.

[1312] Cf. Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 270.

[1313] See for a comparison Michael J. Graetz, 'The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies', 54 *Tax Law Review* 261 (2001), at 261-336. Graetz at 320: *"… in the case of corporations, the idea of residence is largely an effort to put flesh into fiction, to find economic and political substance in a world occupied by legal niceties. It is no accident that we call corporations doing business around the world "multinationals."*

In addition, since many states uphold the concept of corporate nationality to establish nexus, regardless, multinationals have been freely granted an instrument lacking an economic rationale to set-up their legal tiers within taxing jurisdictions employing comparatively higher or lower taxing levels and have their profits being allocated to those jurisdictions accordingly. The global entrepreneur, the multinational, is the first to choose. As corporate tax, from a business economics perspective, constitutes a cost, it is not hard to imagine that multinational firms may employ this arbitrary concept as a tool to attempt to have their rents artificially allocated for tax purposes to the taxing jurisdiction of their preference, i.e., sometimes even without materially altering their underlying business operations.[1314] Indeed, countries have adopted a variety of anti-abuse mechanisms to counter some of the adverse effects that they have created. However, these often are of no substantial assistance.[1315] Perhaps it would be worthwhile to just eliminate the concept of corporate nationality to establish tax jurisdiction.

6.3.3.2.3 The shallowness of corporate residence (real seat system; place of effective management)

Corporate residence: a physical-geographical connecting factor

References for nexus establishment purposes to physical-geographical connecting factors rather than formal-legal criteria may be recognized in the concept of corporate residence, the 'domicile principle'. Corporate residence is used by various countries, e.g., Germany, Luxembourg, Hungary and the Netherlands, to determine a company's residence for tax purposes, and with that its unlimited liability to corporate tax under domestic tax law.[1316] Corporate residence constitutes a subjective, *ad personam*, taxing principle, established by reference to the presence of company management. Various countries, e.g., Hungary, Luxembourg, and Germany, require domestically formed companies to be managed within their respective domestic territories to even exist under their domestic civil laws, i.e., the so-called 'real seat system'.[1317] In these countries transfers of management to abroad will, as a general rule, cause the entity to cease to exist legally.[1318] This is not the case with 'incorporation seat systems', used for instance by the Netherlands and the United Kingdom. The Netherlands refers to the company's place of effective management to establish its corporate tax residence. Real seat transfers from the Netherlands to abroad, e.g.,

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[1314] See Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 8 on 'corporate inversions' in US tax practice*: "Another (…) problem is that the current system is based on an increasingly artificial distinction between MNEs whose parent is incorporated in the United States and MNEs whose parent is incorporated elsewhere. The former, but not the latter, are subject to worldwide taxation with its attendant complexities (which are primarily the foreign tax credit and Subpart F). But in today's world, this distinction is less and less meaningful for MNEs as the sources of capital, location of R&D, location of production, and location of distribution become increasingly globalized. The current distinction has led to a spate of inversion transactions, in which U.S.-based MNEs formally shift the location of incorporation of their parent offshore without changing the location of any of their business activities. Arguably, it has also encouraged takeovers of U.S.-based MNEs by larger foreign-based MNEs who can benefit from territorial systems of taxation."* See on the matter also U.S. Department of the Treasury, Office of Tax Policy, 'Corporate Inversion Transactions: Tax Policy Implications', Doc 2002-12218 (31 original pages), 2002 TNT 98-49, May 21, 2002.

[1315] See OECD, *Addressing Base Erosion and Profit Shifting, OECD Publishing, 12 February 2013, at Chapter 5.*

[1316] See for instance, Article 2(4) Dutch Corporate Income Tax Act 1969. In the Netherlands, companies incorporated under Dutch law, i.e., companies having a Dutch nationality, their nationality is used to deem their corporate tax place of residence in the Netherlands. Under Dutch corporate income tax law, a company's place of residence is generally determined by reference to its place of effective management.

[1317] Notably, the real seat approach may also be acknowledged to express the nationality principle in international taxation, as a transfer of the seat to abroad will cause the entity to cease to exist. A German GmbH, for instance, has a German nationality as it necessarily needs to be managed in Germany in order to legally exist. However, as management activities necessarily need to be performed at a geographical location, I categorize the 'real seat' under 'residence', i.e., by reference to its meaning as the 'place of effective management', activities that need to be performed at a particular geographic location as well. This enables me to argue in the following paragraphs that the 'place of management', actually is a location of source/situs/origin. Analytical categorizations in this respect in international taxation are not further discussed.

[1318] Notably, within the European Union the Court of Justice has made intra-European Union cross-border transfers of real seats of corporations possible, also in respect of entities formed under incorporation seat civil law systems. See Court of Justice, Cases C-378/10 (*VALE*) and C-210/06 (*Cartesio*).

Luxembourg, do not cause companies incorporated under Dutch law to cease to exist as the Netherlands is an incorporation seat country. In international tax law, the place of residence of such Dutch-Luxembourg 'dual resident' companies for double tax treaty application purposes is typically governed by the 'tie-breaker rule' in the applicable tax treaty, which attributes the company's place of residence to the country within which its place of effective management is situated.[1319]

Where nexus is established accordingly, a physical-geographic criterion, the location of the company's managers, decides the location of (residual) corporate income. Typically, the use of the residence principle entails a worldwide tax liability as well. Indeed, the state claiming tax entitlement on the basis of the residence principle subsequently steps down to provide double tax relief in respect of the taxable entity's foreign source income, i.e., to secure single taxation.[1320] However, the residual of the corporation's profits is assigned for tax purposes to the country of the corporation's residence.

Seemingly straightforward at first glance; arbitrary and utterly complex in the end

Such an approach referring to the management location for profit attribution purposes seems relatively straightforward at first glance. The place of effective management, in principle, provides for a more substantive tax jurisdiction concept than corporate nationality does, as it implies the actual undertaking of economic activities by persons at a certain geographic location. Viz., it aims at discovering the geographic location where the people responsible for the entity's operations perform their management tasks and functions. It refers to the location where the competent and responsible board members in fact govern the legal entity.[1321] Accordingly, the place of effective management represents a geographic location where the multinational firm produces parts of its rents. Namely, also at that location, the firm brings together production factors, firm inputs, labor. A group company's place of residence for tax purposes may therefore be considered to constitute an expression of the supply view of income, referring to the geographical source of income at origin.

However, the residence principle tends to operate quite arbitrarily in practice. In reality, the place of effective management is typically determined by reference to ceremonial events, such as the location where the board of directors meets and decide on key corporate affairs.[1322] Being neatly assisted by the 'as made available' separate entity approach for corporate tax purposes, a multinational may deploy the concept of corporate residence for its benefit by setting up a new company in (or merging it into) any jurisdiction it wants, making sure to arrange that the necessary ceremonial events take place within that jurisdiction, and, accordingly have the (residual) profits of the investments undertaken through that company being allocated to that jurisdiction. Indeed, a particular group company may have its place of tax residence within a certain taxing jurisdiction for the single reason that the board decisions concerning that company have been taken there more or less randomly. In practice, this is sometimes referred to as 'fly-in fly-out management'. The actual presence of economic activities undertaken within a nation state's territories through such a separately taxed group company could indeed actually be quite moderate, yet to establish a tax residence within that country. The increased mobility of labor, i.e., the mobility of corporate management in this

[1319] See Article 4(3) OECD Model Tax Convention. As double tax conventions typically apply only bilaterally, conflicting taxing principle issues may not be resolved in cases where three countries are involved. Issues for instance arise when a national of a certain country (Country A) resides in a second country (Country B) and derives income from sources situated in a third country (Country C), and is consequently taxed by all three countries involved. The outcome of the application of the tie-breaker rule in the double tax convention in place between Countries A and B which identifies the taxpayer as a country B resident may not apply beyond that treaty's scope of application – i.e., it is arguable whether the taxpayer involved may be regarded as a Country B resident under the double tax convention in place between Countries A and C. The treaty texts do not satisfactorily resolve such triangular issues, i.e., some extensive treaty interpretation is required to arrive at such a conclusion. This is not further discussed.

[1320] See Article 5 OECD Model Tax Convention in conjunction with Art. 7 OECD Model Tax Convention.

[1321] Of relevance is the location where the decisions regarding the entity's key affairs are taken. Where do they take place? Where are the board meetings held? Where do the director's reside? At which location does the entity keeps its books? Where does the shareholders' meeting take place?

[1322] Cf. Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 270.

respect, has the consequence that the establishment of a group company's place of tax residence and its subsequent unlimited liability to local corporate taxation accordingly ends up being a somewhat arbitrary exercise. The arbitrage potential especially holds when it is recognized that the residual profits derived from the operations carried on through that company are subsequently allocated entirely to the residence jurisdiction. Viz., as multinational firms are basically free in their decision to geographically locate their subsidiaries for corporate tax purposes, these residual profits produced become mobile for tax allocation purposes, ending up at least to some extent being subject to the discretion of the respective multinational firm.

Further, reality reveals that the matter may be more complex than it initially seems. Even if the location of management is acknowledged as one of the factors where income originates, a multinational in fact does not have a single place of residence. It does not reside somewhere, as it operates globally. Indeed, the management functions may be performed in a range of countries, and, in reality they are. *"Management personnel may be geographically dispersed rather than being located in a single central location."*[1323] Today, even basic headquarter functions may be split and located in different countries.[1324] Modern telecommunication techniques have exacerbated matters. Videoconferencing, internet, intranet and e-mail have enabled directors to discuss and decide on matters without physically being at the same location.[1325] Take for instance a group of directors working from a range of countries discussing and deciding on corporate affairs through secured intranet trafficking or videoconferencing. How would one identify any of the multinational group company's places of residence, if corporate management is dispersed across various countries in such a way? I would not know, to be honest.

Perhaps, the establishment of residence on the basis of the corporation's place of effective management may therefore ultimately prove unworkable as the digitized global economy diminished the need for the board to meet at one physical location.[1326] Some countries, therefore, have created administrative safe harbors to facilitate matters for the purpose of attracting corporate headquarters to their jurisdictions by providing legal certainty in this area.[1327] Further, the effective management of a controlled group company may even be effectively outsourced to trust offices. In summary, there is not necessarily much to it to constitute *the* effective place of management to establish nexus within the taxing jurisdiction of choice (and the allocation of the residual as a consequence). This, notably, holds true even if it would be feasible to unambiguously identify the location of effective management in the first place.

It may therefore not come as a surprise that multinational firms in search of reducing global tax costs may use their discretionary powers in this area to create a taxable presence in taxing jurisdictions imposing lower than average global AETRs. Indeed, the decision on where to locate corporate headquarters is similar to any other location decision, as headquarters activities are just one in a variety of functions performed within the multinational (while being awarded the residual profit of the company involved).[1328] It is no secret that, despite political

[1323] See OECD, *Addressing Base Erosion and Profit Shifting, OECD Publishing, 12 February 2013, at 25.*
[1324] See Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 710. Devereux refers to Desai for some verification.
[1325] See also Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 528.
[1326] Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000), at 1596.
[1327] In the Netherlands, for instance, a ministerial decree is in place providing the required 'substance criteria' with regards to so-called group 'servicing entities' or 'flow-through entities' (in Dutch: 'dienstverleningslichamen') for automatic information exchange purposes; Ministerial Decree of 22 December 2011, No. BWBR0030973 (in Dutch: 'Uitvoeringsbesluit international bijstandsverlening bij de heffing van belastingen'). Substance requirements and accompanying administrative rules to obtain a ruling (APA/ATR) from the Dutch tax authorities on the tax implications of a certain transaction or set of transactions are found in a range of decrees; Ministerial Decree of 3 June 2014, Nos. DGB 2014/296M, DGB 2014/3101, DGB 2014/3102, DGB 2014/3098, and DGB 2014/3099.
[1328] See Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 710-711. Devereux argues that management is just one in a number of functions performed for questioning the validity of a government that seeks to effectively tax multinationals on their worldwide income.

pressures to the contrary, nation states compete with each other in response to multinational location decisions to persuade multinational firms to set-up (local) headquarters, holding companies, and financing companies within their territories.[1329] That is, by subsequently granting them some kinds of beneficial tax treatment if they do so (so-called 'headquarter tax havens').[1330] Through such means, states may seek to attract management and financing activities from abroad – or to preserve such activities at home.[1331] Empirical evidence suggests that (intermediate) headquarter locations, like other location decisions, are driven by taxation.[1332] It hardly needs to be argued that this reality exacerbates the 'race to the bottom', putting additional pressures on tax revenues, budgets and the financing of the welfare state in the end.[1333]

Murky tax framework: 'place of residence' actually is 'place of source'

In addition to this, the tax concept of 'place of residence' is being applied within a somewhat murky conceptual framework. As each company, as a rule, constitutes a single taxpayer, the scenario may arise that a subsidiary company that is effectively controlled by its parent company, for tax purposes, nevertheless constitutes a single taxpayer, recognized separately from its parent, having a place of effective management that is separate from its controlling parent company's. In addition, that subsidiary's effective place of management does not necessarily correspond with the parent's place of effective management, even when it is effectively controlled by that parent company. This holds true, regardless of whether the multinational firm concerned is ultimately governed in a centralized manner, something that in today's reality does not really seem an exception to the rule.[1334] This effect is caused by the adopted separate entity approach. A multinational firm accordingly not only constitutes a multi-national for corporate tax purposes, it constitutes a multi-resident as well.[1335]

To be honest, I find this tax reality somewhat hard to wrap my mind around. In Chapter 4, appreciating the theory of the firm, I argue for the recognition of the multinational firm as a single taxable entity, since it economically is a single unit. Under such a unitary approach, *the* tax place of effective management of a group company to determine its domicile backslides into *a* place of management, an expression of the *situs* principle discussed in the following

[1329] See for a comparison Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 9, arguing that *"[t]he literature has consistently found that MNEs are sensitive to corporate tax rate differences across countries in their financial decisions."*

[1330] Reference can be made at this place to the soft-law efforts undertaken within the European Union's institutions addressing the use of such 'harmful tax regimes' within the European Union. In the late 1990s the Council of Economics and Finance Ministers adopted the Code of Conduct for business taxation; see Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy (OJ 98/C 2/01). With that it initiated a 'soft law' process 'peer pressuring' the European Union Member States to roll back existing harmful tax measures (e.g., the former Belgian Coordination Center regime, and the former Dutch tax ruling practice), and to refrain them from introducing any such measures in the future. This process is being monitored by the Code of Conduct Group up until present.

[1331] See Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000), at 1582-1583. Avi-Yonah notes at 1583 that: *"[t]he current situation resembles a multiple-player assurance ("stag hunt") game: all developed countries would benefit if all re-introduced the withholding tax on interest because they would gain revenue without the risk that the capital would be shifted to another developed country. However, no country is willing to attempt to spark cooperation by imposing a withholding tax unilaterally; thus, they all "defect" (that is, refraining from imposing the tax) to the detriment of all."*

[1332] Cf. Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 698-719. For some verification, Devereux refers to Johannes Voget, 'Headquarter Relocations and International Taxation', *Oxford University Centre for Business Taxation working paper* 10/08. See also Johannes Voget, 'Relocation of headquarters and international taxation', 95 *Journal of Public Economics* 1067 (2011, No. 9-10), at 1067-1081.

[1333] See also Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

[1334] See, e.g., OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing, 12 February 2013, at Chapter 3.

[1335] See for a comparison Michael J. Graetz, 'The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies', 54 *Tax Law Review* 261 (2001), at 320. To secure that the subsidiary company does cause the foreign parent to have nexus in the subsidiary country, Article 5(6) OECD Model Tax Convention provides that the subsidiary does not constitute a permanent establishment of its parent.

section of this chapter.[1336] If seen from that perspective, the tax place of residence of a group company actually and merely constitutes a geographical source of the business income derived by the taxable multinational firm. In such an alternative context recognizing economic realities, the place of residence would actually constitute a place of source. This conceptually renders domicile to a species of the *genus situs*.[1337] Please note that the presence of firm inputs – nexus – within a taxing jurisdiction, such as a place of management, does not explain the portion of the firm's business income that is to be allocated to that nexus location. The issue of allocation is an analytically separate matter.

All in all, these matters render the concept of corporate residency a relatively shallow tool to base tax jurisdiction upon. This particularly holds true if the subsequent allocation of the entity's residual profit to the residence state is taken into consideration.[1338] Although allocation is further discussed separately in section 6.3.4, it may be fair to say at this point that under the current use of the residence principle in international taxation, a bit too much weight seems to be assigned for tax jurisdiction purposes to the country of 'effective management'. Particularly when it is recognized that the undertaking of management functions is just one in a range of functions performed within multinational firms.

6.3.3.2.4 Situs, perhaps, but many of its expressions in international tax have reached breaking points

Situs: a physical-geographical connecting factor aimed at locating income at its origin

References for tax jurisdiction establishment purposes to physical-geographical connecting factors may further be recognized in the concept of source, the '*situs* principle'. The *situs* principle is generally used by nation states to determine a foreign, i.e., a non-national or non-resident, company's taxable presence within its jurisdiction. Typically, states subject foreign entities that operate commercial activities within their territories to a limited liability to tax. *Situs* constitutes an objective, *in rem*, taxing principle, established by reference to physical-geographical connection factors within the respective taxing jurisdiction, such as the presence of tangible property (branch, factory, et cetera) or individuals (representatives, 'significant people'). Accordingly, the international tax regime adopts a substantive connecting factor that seeks to localize income producing firm inputs. Its purpose is to identify the geographic location where the entrepreneur brings together production factors for the purpose of producing profits, i.e., the geographic origin of income.

Within the international tax regime, consensus has been established that the country of source has the primary entitlement to tax business proceeds. To secure single taxation, these 'source states' generally disregard foreign source income items for tax calculation purposes. In Chapter 3 I argue that this differential tax treatment on the basis of corporate residence or nationality entails an (in)directly discriminatory tax treatment.[1339] Typically, although the

[1336] Notably, with regards to shipping companies tax jurisdiction is attributed completely to the country where the effective management of the enterprise, i.e., the business operation, is situated. See Article 8 OECD Model Tax Convention. Profit is exclusively allocated to that location. As a consequence, this incentivizes shipping companies to manage their business operations from a low-taxing jurisdiction. See on this matter, Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000), at 1595.

[1337] See for a comparison Klaus Vogel, '"State of Residence" may as well be "State of Source" – There is No Contradiction', 59 *Bulletin for International Taxation* 420 (2005), at 420-423. Also Vann recognizes the corporate residence rule as *"at bottom a sourcing rule like the PE rule…"* See Richard J. Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World', 2 *World Tax Journal* 291 (2010), at 293-294.

[1338] Cf. Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 527.

[1339] As discussed in Chapter 3, I find it difficult to appreciate why nation states should be entitled to subject foreigners directing investment towards their territories to diverging tax burdens solely on the basis of the tax place of residence of the foreigner receiving the returns on their capital investments. Notably, subsequent to the designation of the residence state for tax convention application purposes the distributive rules divide the taxing entitlements among the countries of source and residence. Typically the residence state steps down in favor of the source state and provides double tax relief. In non-treaty scenarios the similar often goes, however then on the basis unilateral means. As double tax conventions typically apply only bilaterally, conflicting taxing principle issues may not be resolved in cases where three countries are involved. Issues for instance arise when a resident of a certain country (Country A) derives

foreign countries of residence and nationality step down to provide double tax relief in respect of the taxable entity's local source income to secure single taxation,[1340] the residual of the corporation's profits, that is, the profits derived to the extent that they are not geographically attributable to local sources, as said, is assigned for tax purposes to the first mentioned home countries.

Both *situs* and origin essentially refer to the location of income production. Both address the supply-side of income, firm inputs and hence the place where the entrepreneur employs its production factors in its business process. Accordingly, conceptually, as a nexus at origin concept, *situs* indeed merits some consideration. Viz., if it is assumed that the nexus expressions that are currently used in international taxation operate adequately, income can be located at its origin. Note that the subsequent evaluation of that location, i.e., the matter of allocation should analytically be kept separate in this respect. Then, the question is whether these nexus expressions serve their purpose.

Situs expressions in international tax: a motley collection[1341]

The international tax regime, unfortunately, makes use of a motley collection of nexus expressions referring to *situs*. Some of these make some sense, others do not.[1342] Of these expressions, the place of effective management has already been identified in the above as being one of them – although in the disguised appearance of an expression of the residence principle. Notably, the place of effective management is commonly used as a derivative to establish the taxable presence of another taxpayer as well. This, for instance, is the case with dividend, interest, and royalty payments or (technical) service fees that 'arise' in the source state for double tax convention allocation purposes.[1343] For taxing right allocation purposes

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business income from carrying on a business through a permanent establishment situated in a second country (Country B) to which income can be attributed which arises from sources in a third country (Country C), and is consequently taxed by all three countries involved. The treaty texts do not satisfactorily resolve such triangular issues. As the taxpayer at hand resides in Country B nor Country C, the double tax convention in place between these countries is not applicable (i.e., as double tax conventions only apply to residents of one of the contracting states). Consequently, Country B in which the permanent establishment is situated is not required to provide for double tax relief for taxes levied in Country C. Only in cases where both Countries A and B are European Union Member States, Country B would be required to provide for relief on the basis of the free movements. See Court of Justice, case C-307/97 (*Saint Gobain*). This is not further discussed.

[1340] Art. 5 OECD Model Tax Convention in conjunction with Art. 7 OECD Model Tax Convention.

[1341] The header of this section referring to 'a motley collection' has been drafted in the style of Kemmeren, see Eric C.C.M. Kemmeren, 'Source of income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach', 60 *Bulletin for International Taxation* 430 (2006), at 432.

[1342] See for a comparison Brian J. Arnold, 'Threshold Requirements for Taxing Business Profits under Tax Treaties', 57 *Bulletin for International Taxation* 476 (2003), at 492 Arnold, who concludes that *"[t]he existing threshold requirements for source-country taxation in the OECD and UN Models are a curious mix of principled policy and practical considerations. For most business, a relatively high threshold consisting of a fixed place of business is necessary. (…) Some business activity, such as entertainment, however, is taxable by the source country without any minimum threshold at all. There is no principled explanation for the lack of a threshold with respect to certain types of business profits."* Arnold argues at 491 that, in principle, the same threshold requirement should apply to all types of business profits. See for a comparison Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 544. Avi-Yonah refers to the difficulties encountered in international taxation that, in general, revolve around the classification and assignment of sources approach under the double tax convention networks of states. Double tax conventions typically require a classification of income items into e.g., business profits (art. 7), inter affiliate transactions (art. 9), royalties (art. 12), service fees (art. 12), dividends (art. 10), capital gains (art. 13), et cetera, prior to the assignment of the accordingly classified income items to geographical sources. As the geographical assignment differs per class of income, the sourcing process becomes relevant. Problematically, though, is that it is not always easy to properly disentangle the contracts underlying the provisions of goods or services. Should, for instance, a lump sum credit card payment for a downloaded 5 year software license (e.g., a firewall) be considered a sale of a good, the remuneration in return for the provision of a service, a gain on a disposal of intellectual property or a royalty payment for the use of a copyright? The issue arises both as regards intra-group transactions and transactions between third parties. Avi-Yonah argues to take a step back and ask whether having separate source rules for each category of income makes any sense. He arrives at the conclusion to sidestep the classification issue and merely decide on whether the proceeds should be considered active (direct investment) or passive (portfolio investment) and adopt a single sourcing rule to apply to them. That could, for instance, be a quantitative nexus criterion (economic presence test, gross-income threshold rule, et cetera). Notably, the combined profit split approaches in transfer pricing would resolve the matter as regards the intra-group transactions (articles 9) since the tax consolidation (combined reporting) would eliminate the issue.

[1343] For tax treaty application purposes, royalty payments sometimes include fees for (technical) services rendered. That is, technical service fees are commonly considered to constitute 'royalties' under the broadened royalty article, typically Article 12, in the tax treaties concluded by capital importing developing countries and countries with transition economies.

under double tax conventions concluded, the place of tax residence of the company in which the shares are held, the tax residence of the debtor, the licensee and the customer of the technical service (i.e., the payor) typically constitute the geographical source of the income producing activities of the shareholder, the creditor, the licensor and the service provider (i.e., the payee), respectively.[1344] That constitutes the location where these payments 'arise' and the *situs* of the income accordingly.[1345] It may not come as a surprise that the utilization of the internationally mobile 'place of residence' for derivative nexus establishment purposes triggers arbitrage issues in intra-firm environments, which are similar to those set forth in the section above.[1346] This particularly holds true as source tax rates applied by countries differentiate, both under the application of domestic tax systems and double tax convention networks. These rate differentials trigger 'tax treaty-shopping' opportunities, i.e., the channeling of income streams through interposed low-taxed flow-through entities to reduce global AETRs,[1347] as well as 'most-favored nation' issues (i.e., tax discrimination under a synonym analytically).[1348]

The perhaps best-known *situs* expression in international tax is the 'permanent establishment' threshold.[1349] It is used in some variations, the most common of which is the 'fixed permanent

[1344] An exception to this rule applies in the event that the payments are attributable to a permanent establishment of the recipient situated in the other contracting state. This is not further discussed.

[1345] Such taxing rights typically are effectuated by subjecting these payments to withholding taxes levied on a gross-basis.

[1346] See for a comparison Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 271: *"Source rules are sometimes simple and sometimes quite complex. Some are difficult to manipulate, whereas others invite manipulation. (…) Some source rules depend on the taxpayer's residence. Because residence is easily manipulated, those source rules also are easily manipulated."* McIntyre further refers to the *"US rule that determines the source of income from the sale of goods by reference to the place where title to the goods passes, as a well-known example of a source rule that is easily manipulated"*. Please note that, as said, an exception to the rule is the location where the income 'arises'. In international taxation, dividends, interest, and royalties, as well as in certain cases fees for (technical) services rendered seem to 'arise' for tax base allocation purposes at the location of the customer and thereby the destination jurisdiction. That is, as it designates the tax base to the place of the customer's residence or the place where it carries on a business through a permanent establishment. Accordingly, these attributional rules in international tax echo those in European Union value added taxation.

[1347] To counter treaty shopping countries typically respond by introducing complex anti-avoidance clauses in their double tax treaties, such as 'limitation on benefits clauses', or 'main purpose tests'. See OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Preventing the granting of treaty benefits in inappropriate circumstances*, OECD Publishing, Paris, 16 September 2014, OECD, and OECD Committee on Fiscal Affairs, *Public Discussion Draft BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances, 14 March 2014 – 9 April 2014*, OECD Publishing, Paris, 2014. The OECD suggests countries to adopt either a limitation on benefits clause' or a 'principle purpose tests', or a combination of these measures in their double tax conventions networks. Traditionally, the matter has been sought to be resolved by requiring that the recipient of the payment qualifies as the 'beneficial owner', i.e., the 'owner of the income'. The introduction of anti-abuse provisions, nevertheless, has been considered necessary as the 'beneficial ownership criterion' typically is interpreted quite formally and, hence, is not always too useful. The beneficial owner is the person (individual or entity) that is legally entitled to dispose of the receipts. That is, even if the (interposed) entity that is legally entitled to the payments is controlled by a shareholding company (informally referred to as the 'ultimate beneficial owner'. See on this matter the British *Indofood* case (United Kingdom Court of Appeal, 2 March 2006, [2006] EWCA Civ 158 (*Indofood*) and the Canadian *Prévost* case (Canada Federal Court of Appeal, 26 February 2009, 2009 FCA 57, [2010] 2 F.C.R. 65 (*Prévost*). For some discussion and analysis of the concept of beneficial ownership, see OECD, *2014 Update to the OECD model tax convention*, OECD, Paris, 15 July 2014, as well as Jan Gooijer, 'Benficial Owner: Judicial Variety in Interpretation Counteracted by the 2012 OECD Proposals?', 42 *Intertax* 204 (2014), at 204-217. On limitation on benefits clauses, see John Bates et al, 'Limitation on Benefits Articles in Income Tax Treaties: The Current State of Play', 41 *Intertax* 395 (2013), at 395-404. The international tax regime does not resolve the issue at its roots, e.g. in a manner as suggested in Chapter 3, by tax-treating the multinational group as a single taxable entity. Such an approach would eliminate intra-firm legal transactions, and, with that, the arbitrage possibilities.

[1348] That is, the differential tax treatment of a non-resident taxpayer from one country in comparison to the non-resident taxpayer of another. As discussed in Chapter 3, I find it difficult to appreciate why nation states would be entitled to subject foreign economic operators directing investment towards their territories to diverging tax burdens solely on the basis of their tax place of residence.

[1349] Worth noting also is the concept of the 'dependent agency permanent establishment'. Characteristic is its orientation towards the presence of the production factor of labor, a person performing representative functions within a country's territories on behalf of its principal, thereby establishing the latter's taxable presence in that country. The representative can be an individual or a company. As the representatives of companies operating as an agent, in the end, are individuals as well, also in that event the matter boils down to the presence of labor. The agency permanent establishment concept requires the representative to be economically dependent from its principal, so third-party representatives, commissionaires and agents fall outside its scope. Further, as the concept requires the representative to be able to legally bind its principal, the presence or absence of an agency permanent establishment typically is under the multinational firm's control. This renders the agency PE concept a relatively meaningless

establishment'.[1350] The permanent establishment concept constitutes a qualitative threshold criterion for establishing nexus within a taxing jurisdiction. A permanent establishment is not a legal entity or a taxable entity. Essentially, the concept is oriented towards tying down the physical-geographical presence of the entrepreneur's business organization within the taxing jurisdiction.[1351] The OECD for instance, even considers the presence of a permanent establishment attainable in the absence of people.[1352] Characteristic of the fixed permanent establishment is the orientation towards the presence of tangible capital, as it aims at identifying a fixed place of business through which the entrepreneur carries on its business activities, i.e., a physical presence such as a premise, store, or factory.[1353] Accordingly, a person's non-physical presence within a jurisdiction, e.g., by means of a data network or an e-store, is not captured due to the lack of a physical connection with the taxing state.[1354]

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instrument to establish nexus at origin. Although it should be said that the concept does have some appeal, as, e.g., an employee may also trigger the taxable presence of a multinational firm at origin. However, the concept of 'significant people functions' may be considered more suitable in this respect. See further hereunder. For some elaboration on agency permanent establishments, see, Keith R. Evans, 'Leased Equipment: When Does a Permanent Establishment Exist?', 50 *Canadian Tax Journal* 489, at 507-509, Jacques Sasseville et al, 'General Report – Is there a permanent establishment?', in International Fiscal Association, *Cahiers de droit fiscal international* (2009) 17, at 49-55, Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006), at 266-280, Sergio André Rocha, 'Agency Permanent Establishment 'Brazilian Style': Taxation of Profits Earned Through Commission Merchants, Agents and Representatives', 41 *Intertax* 444 (2013), at 444-449, and Alessio Persiani, 'Some Remarks on the Notion of Permanent Establishment in the Recent Italian Supreme Court Jurisprudence', 40 *Intertax* 675 (2012), at 675-682. On the issues involving so-called 'commissionaire structures', both generally and with a particular focus to the Norwegian international tax system, see Rainer Zielke, 'Commissionaire Structure as an Agency Permanent Establishment (PE): Low Risk for Foreign Principals Constituting a PE in Norway – Dell Products v. Government of Norway, Decision of the Norwegian Supreme Court of 2 December 2011', 40 *Intertax* 494 (2012) at 494-496.

[1350] See Art. 5 OECD Model Tax Convention. Alternative usages of the permanent establishment threshold (see the OECD and UN Model Tax Conventions and the actual double tax treaty networks of countries) typically refer to the time period during which the economic activities concerned are carried on. For instance, the 'construction permanent establishment' on construction activities generally refers to a period lasting at least 12 months, the 'offshore permanent establishment' on natural resources exploration or exploitation activities commonly requires a period exceeding 30 days (the term varies per treaty), the 'substantial equipment permanent establishment' on the use of equipment or machinery related to such exploration and exploitation activities often call for a period in excess of 12 months, and the 'services permanent establishment' on the place of services performed generally sets forth a time period to lapse of at least 6 months. This, however is not always the case. The 'insurance permanent establishment rule', for instance, refers to premiums collected in the territory, or the insurance of risk located within the territories of one of the contracting states, without making reference to a time period requirement to be met. Further, something similar holds with respect to the establishment of nexus regarding entertainment activities of artists and sportsmen (art. 17 OECD Model Tax Convention). In this respect, nexus is established at the place of show performance, irrespective of its duration. Regarding immovable property, taxing rights are allocated to the country where the real estate is situated. For some further elaboration and analyses of the PE concept, see OECD, Centre for Tax Policy and Administration, *Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment), Revised Public Discussion Draft*, OECD, Paris, 19 October 2012, Joel Nitikman, 'The Painter and the PE: What Constitutes a Fixed PE in Canada', 56 Tax Notes International 681 (30 November 2009), and Keith R. Evans, 'Leased Equipment: When Does a Permanent Establishment Exist?', 50 *Canadian Tax Journal* 489. Notably, on the offshore PE rules in the Dutch double tax treaty network see Jean-Paul van den Berg, 'The Netherlands - Is there a permanent establishment?', in International Fiscal Association, *Cahiers de droit fiscal international* (2009) 463, at 463-481. See also Jacques Sasseville et al, 'General Report – Is there a permanent establishment?', in International Fiscal Association, *Cahiers de droit fiscal international* (2009) 17, at 17 – 63. Sasseville and Skaar refer to the various tests to be performed to scrutinize whether the permanent establishment threshold is met, i.e., the 'place of business test', the 'location test', the 'duration test', the 'right to use test', the 'business activity test', and the 'business connection test'.

[1351] Cf. Jacques Sasseville et al, 'General Report – Is there a permanent establishment?', in International Fiscal Association, *Cahiers de droit fiscal international* (2009) 17, at 17-63, and Jean Schaffner, 'The Territorial Link as a Condition to Create a Permanent Establishment', 41 *Intertax* 638 (2013), at 638-651.

[1352] Example of stand-alone server in Commentary on Article 5 of the OECD Model Tax Convention on Income and on Capital, OECD, Paris, 2010. Interestingly, in its Permanent establishment Attribution Report, the OECD refers to the significant people to allocate corporate profit. Unless I am mistaken, this would mean for the server-permanent establishment in the absence of people that analytically there should be no room for assign a profit to it.

[1353] Cf. Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006), at 266. See for a comparison Jacques Sasseville et al, 'General Report – Is there a permanent establishment?', in International Fiscal Association, *Cahiers de droit fiscal international* (2009) 17, at 23-24, who set forth that the term 'place of business' does not require any presence of human beings. See also Keith R. Evans, 'Leased Equipment: When Does a Permanent Establishment Exist?', 50 *Canadian Tax Journal* 489, at 502, who submits that the human intervention is not a requirement for the existence of a permanent establishment. Further, see OECD, *Commentary on Article 5 of the OECD Model Tax Convention on Income and on Capital*, OECD, Paris, 2010.

[1354] Cf. Jacques Sasseville et al, 'General Report – Is there a permanent establishment?', in International Fiscal Association, *Cahiers de droit fiscal international* (2009) 17, at 23. For some discussion on the permanent

Notably, to foster international trade and administrative convenience, a permanent establishment is deemed absent if the business operations performed within a state are of a preparatory or auxiliary nature.[1355] A controlled subsidiary company, as a rule, is not considered to constitute a permanent establishment of its foreign parent company.[1356] The same holds true for a workforce; by itself, a workforce also does not trigger the presence of a permanent establishment.

Unfortunately, despite its objectives to locate income at its origin, the permanent establishment concept proves poorly equipped to face the realities of today's globalizing economy. The times in which making of a cross-border profit required entrepreneurs to establish a physical presence at a certain location abroad have long since passed. The issue is not a novel one, though.[1357] Traditionally, the international tax regime has encountered difficulties in taxing the remote seller and the remote service provider in the source state.[1358] This being said, however, internationalization and the rise of e-commerce and cloud computing,[1359] as well as the rise of intangible production factors such as intellectual property rights[1360] have, at least, exacerbated things. E-commerce, for instance, has made it possible to sell large quantities of product into a demand jurisdiction without any need to establish a physical presence there.[1361] *"[T]he growing importance of the service component of the economy, and of digital products that often can be delivered over the Internet, has made it possible for business to locate many productive activities in geographic locations that are distant from the physical location of their customers."*[1362] Contemporary developments in business realities have rendered the permanent establishment as a foundation concept to establish nexus at origin an archaic relic from yesterday's bricks-and-mortar industries.[1363]

This evidently triggers inequities and arbitrage. What could be considered equitable in using a nexus concept that is able to tax the proceeds from the old-fashioned record shop down the street, while being unable to properly subject to tax the commercially identical proceeds from an e-record shop, i.e., a website from which a consumer may download music on its portable media player for a fee paid through its credit card? And this simply because the website establishes a virtual presence, which is left untaxed for lacking a physical-geographic connection with the taxing jurisdiction involved? I do not see any reason why new-economy

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establishment concept in the area of e-commerce, see OECD, *Commentary on Article 5 of the OECD Model Tax Convention on Income and on Capital*, OECD, Paris, 2010, par. 42.1-42.48.

[1355] See for some discussion Jacques Sasseville et al, 'General Report – Is there a permanent establishment?', in International Fiscal Association, *Cahiers de droit fiscal international* (2009) 17, at 40-43.

[1356] Article 5(7) OECD Model Tax Convention.

[1357] Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 511.

[1358] The latter, e.g., may be recognized to explain the usage of the 'service permanent establishment' in Article 5(3)(b) of the United Nations Model Double Taxation Convention between Developed and Developing Countries, establishing situs at the location of service performance. For an analysis of the 'Service PE' from the perspective of the Austrian international tax system, see Stefanie Steiner et al, 'Services and the Service PE under Treaty Law from an Austrian Perspective', 40 *Intertax* 566 (2012, No. 10), at 566-572.

[1359] See OECD, OECD Committee on Fiscal Affairs, *Public Discussion Draft BEPS Action 1: Address the tax challenges of the digital economy, 24 March – 14 April 2014*, OECD Publishing, Paris, 24 March 2014, OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Addressing the tax challenges of the digital economy*, OECD Publishing, Paris, 16 September 2014, as well as Aleksandra Bal, 'Tax Implications of Cloud Computing – How Real Taxes Fit into Virtual Clouds', 66 *Bulletin for International Taxation* 335 (2012), and Oliver Heinsen et al, 'Cloud Computing under Double Tax Treaties: A German Perspective', 40 *Intertax* 584 (2012, No. 11), at 584-592.

[1360] See on this matter, e.g., Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 5-17, who refer to the changes in the way MNEs conduct international business, i.e., from the traditional way on a country-by-country basis to the adoption of new global business models, such as e-commerce and shared services or intangible assets. See for a comparison also Lawrence Lokken, 'The Sources of Income From International Use and Dispositions of Intellectual Property', 36 *Tax Law Review* 233 (1980-1981), who recognizes issues in geographically locating proceeds from intellectual property commercialization.

[1361] See Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000), at 1587.

[1362] See OECD, *Addressing Base Erosion and Profit Shifting, OECD Publishing, 12 February 2013, at* 25.

[1363] See OECD, *Addressing Base Erosion and Profit Shifting, OECD Publishing, 12 February 2013.* For some analysis and discussion involving the permanent establishment concept in the context of some recent OECD developments from a German international tax law perspective, see Lukas Hilbert et al, 'OECD Discussion around the Definition of Permanent Establishments: A German view on Proposed Amendments to the Model Commentary and Their Effect on Business Profit Allocation and International Assignments', 40 *Intertax* 462 (2012), at 462-476.

ventures should be tax-favored over old-school bricks-and-mortar investments. The arbitrage is obvious. Local markets may be serviced without things leading to effective business taxation. The absence of permanent establishment entails that e-business proceeds are attributed to the respective entity's country of residence.[1364] However, as the backstop nexus concept of tax residence is mobile, the current system facilitates firms to accomplish their e-proceeds to being substantively left untaxed by any jurisdiction. That is, as they are able to set-up legal entities for this purpose in low-taxing jurisdictions. This encourages tax-induced arbitrary profit shifting arrangements. It is no secret that this is today's reality.[1365] This fundamentally undermines the single tax principle as well as the benefits principle and ability to pay principle.[1366] As a result of this, various scholars have suggested amending the permanent establishment threshold concept. That is, for instance, by reference to quantitative tests, such as supply-side 'factor presence tests' (payroll or capital threshold tests), or demand-side VAT-style remote seller rules (turnover threshold tests).[1367] The alternatives to the current permanent establishment concept are further discussed hereunder in sections 3.3.4 and 4.4.2.2 of this chapter.

6.3.3.3 Situs, perhaps indeed, but only by reference to 'significant people'

'*Significant people functions': its current use in international taxation*

Notably, one expression of nexus at origin in international taxation has not yet been discussed: the 'significant people functions', i.e., the performance of economic activities by people relevant to the multinational firm, i.e., the firm's workers effectively. Although not generally being identified as such, it does provide a nexus concept at origin. Notably, it should be mentioned that the concept of 'significant people functions' is discussed at this point on its individual merits, i.e., separate from the context within which it is currently applied in international taxation.

In current international tax practice, the concept of 'significant people functions' is first used in performing the 'functional and factual analysis', one of the building blocks of the generally applied methodology to attribute business profits to taxing jurisdictions.[1368] The concept is embedded in the first step of the 'two-step analysis', i.e., the 'Authorised OECD Approach' on the basis of which business profits generally are attributed to permanent establishments.[1369] The functional and factual analysis is being performed to constitute the various items on the functionally separate permanent establishment's tax balance sheets and tax profit and loss accounts ('nexus'). Moreover, it is employed to identify so-called 'internal dealings', i.e.,

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[1364] See e.g. Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 524 who recognizes that the rise of e-commerce will 'accelerate' a trend towards preferring residence-based taxation over source-based taxation, because it will increase the difficulty of the latter.
[1365] See OECD, *Addressing Base Erosion and Profit Shifting, OECD Publishing, 12 February 2013, at Chapter 2*.
[1366] See for a comparison Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 509, who refers to the undermining of the single tax principle and the benefits principle in this respect. Avi-Yonah argues that the single tax principle is undermined because e-commerce makes it much easier to earn income from cross-border transactions that is not subject to tax by any jurisdiction. The benefits principle is undermined because under current rules income from e-commerce may not be taxable by the source jurisdiction.
[1367] See Walter Hellerstein, 'State Taxation of Electronic Commerce', 52 *Tax Law Review* 425 (1996-1997), at 497-499, and Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 510, who propose to use as a concept to establish nexus for proceeds from electronic commerce a de minimis amount of gross income earned within the taxing jurisdiction. To establish the place of consumption, both Hellerstein and Avi-Yonah refer to the billing address of the customer. By doing that, they essentially advocate the adoption of destination based tax jurisdiction concepts in international taxation. See for a comparison also Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006), at 266-279. Notably, in its recent discussion draft on the digital economy, the OECD refers to modifying the permanent establishment threshold by reference to a new tax nexus standard based on 'significant digital presence'. See OECD, OECD Committee on Fiscal Affairs, *Public Discussion Draft BEPS Action 1: Address the tax challenges of the digital economy, 24 March – 14 April 2014*, OECD Publishing, Paris, 24 March 2014, at 65. In its final report however the OECD seems to indicate that reform proposals would need to be found within the existing international tax framework; see OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Addressing the tax challenges of the digital economy*, OECD Publishing, Paris, 16 September 2014, at 18 and 149.
[1368] Article 7 OECD Model Tax Convention.
[1369] See OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

operations or modes of property transfers within a legal entity equivalent to intra-group legal transactions. It should be mentioned, however, that intra-entity financing arrangements are not recognized as a taxable event. Accordingly, notional interest payments and notional dividend distributions are impossible.[1370] Despite the use of the 'functionally separate entity approach' for taxable profit attribution purposes, economic reality upholds its strongholds here, i.e., the firm as a unitary business. Notably, under the second step in the 'two-step analysis', the taxable business profits are allocated under the application of the arm's length standard ('allocation').

Further, the concept of 'significant people functions' is generally utilized in performing the 'functional and factual analysis' in the area of transfer pricing – i.e., at least its properties are.[1371] In this respect, the concept serves two purposes. First, it is used as one of the 'comparability factors' under the 'comparability analysis'. Second, it is used in the area of transfer pricing to localize firm inputs under the application of the '(residual) profit split method', i.e., under the 'contribution analysis' c.q. the 'residual analysis'.[1372] Notably, here the concept is generally referred to under the term 'functions performed'. With respect to its role in the comparability analysis, the assessment of the 'functions performed' serves the purpose of analyzing intra-firm legal transactions for their economic substance. Similar to the tax-recognition of internal dealings in permanent establishment profit attribution, intra-group transactions are recognized as a taxable event as well.

The role of the concept in the 'first step' in permanent establishment profit attribution is conceptually akin to its role in the 'comparability analysis' in transfer pricing. Analytically, the sole difference is the diverging legal contexts in which the concept applies. A permanent establishment and its head office do not constitute separate legal entities and, accordingly, are incapable of mutually entering into legal transactions. Conversely, the parent and its subsidiary do, allowing them to enter into contractual arrangements with one another. However, as both utilize the '(functionally) separate entity approach' for profit attribution purposes, the matter ends up analytically at the same place, i.e., the '(significant people) functions performed'. The exception to the rule is intra-firm financing. In attributing profit to permanent establishments, intra-entity financing arrangements, as said, generally are not tax-recognized ('unitary approach' rather than 'functionally separate entity approach'; no thin capitalization issues). The converse holds true in transfer pricing with respect to intra-group financing arrangements ('separate accounting', thin capitalization issues). Intra-group legal

[1370] Worth noting is that the OECD seems somewhat ambivalent when it comes to the financing of business operations carried on through permanent establishments. The OECD submits that it does not see much room for recognizing notional debt relationships between the permanent establishment and its deemed functionally separate head office in the absence of external debt. See OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at par. 157. Further, at 29 of its report on the attribution of profits to permanent establishments, the OECD refers to the impossibility for tax allocation purposes to treat one part of an entity as being able to guarantee a risk assumed by another part of the same entity. To substantiate things, the OECD refers at 30 and 99-104 to the internal condition of the permanent establishment that its creditworthiness is generally the same as the enterprise of which it is part. Indeed, this can be considered true, as the OECD sets forth itself, it is based in this respect on the factual situation of the enterprise, the single economic unit. The OECD accordingly seems to promote a unitary approach in this respect. However, when it comes to the attributing of 'free' capital to the permanent establishment, things change a bit. In that respect the OECD amongst others authorizes the 'thin capitalization approach', which basically entails that a debt to equity ratio should be assigned to the permanent establishment by reference to third party equivalents, i.e., as if it were an entity functionally separate from its head office. Consequently, the application of the 'thin capitalization approach' may result in the scenario where the aggregate amount of free capital that is attributed to the permanent establishment may exceed the equity capital in the enterprise as a whole (par. 134). This strikes me as odd as the OECD itself sets forth also that the permanent establishment's creditworthiness is the same as the enterprise of which is it is part. That latter would, I assume, entail that the permanent establishment's free capital – its 'cushion against the crystallization of risks into actual losses' – could not exceed the enterprise's equity. That is, indeed, a unitary approach as implicitly favored by the OECD at earlier places in its permanent establishment profit attribution report. The adoption of a unitary approach accordingly seems to promote the capital approach (and the 'fungibility approach'), i.e., some kind of pro rata parte allocation of equity capital among head office and permanent establishment (see par. 121-127). Yet, that does not correspond with the concept of treating the permanent establishment functionally separately from its head office, as that would promote a thin capitalization approach (and 'tracing approach'). Notably, the converse holds with respect to affiliated entities. That is, with the exception of benefits of multinational synergies in debt financing, referred to as 'passive association'.

[1371] See Article 9 OECD Model Tax Convention.

[1372] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Chapter 2, at section C.3.2., par. 2.118 et seq.

realities – the firm as segregated into separately taxed legal entities – maintain their strongholds here.[1373] This differential tax treatment in the area of profit allocation between head offices and permanent establishments on the one hand and group companies on the other triggers some controversies and discussions in practice as to whether this constitutes discriminatory tax treatment.[1374]

With respect to its role in the application of the '(residual) profit split transfer pricing method', the assessment of 'functions performed' serves the purpose of establishing the location of firm inputs ('nexus'). This is a first step to subsequently evaluate the relative contributions of these firm inputs to the multinational firm profit making through the various multinational group entities. The profit split method is typically applied as a 'last resort' transfer pricing method. It is applied in the event that the general transaction-oriented third party benchmark approach in transfer pricing proves useless, due to the absence of third party comparables. In practice, profit splits are typically employed where the intra-group trade in fact concerns the multinational firm's commercial exploitation of its high-worth, key value-driving intangible assets, such as its property rights over intellectual achievements (e.g., trademarks, brands, patent rights or know-how).[1375] Notably, the issue of evaluating the functions performed is discussed as an analytically separate matter in section 6.3.4.

Situs at origin; 'significant people functions': the profits are where the people are

In its spearhead role under the 'functional and factual analysis' in both profit attribution and transfer pricing, the concept of 'significant people functions' provides a tax jurisdiction concept that is oriented most directly towards identifying the location of the employed production factors. That is, relative to the *situs* concepts mentioned earlier. Under the application of the 'functional and factual analysis', one essentially aims at identifying the nature of the economic activities undertaken within a certain jurisdiction ('functions performed'), the utilization of assets in this respect ('assets used') and the commercial risks that are incurred in the process ('risks assumed'). Subsequently, one scrutinizes the equity and debt capital that is required to objectively bear these risks.[1376]

[1373] Worth noting is that the OECD seems to take a somewhat ambivalent approach when it comes to subsidiary financing. Opposite to the intra-entity equivalents, intra-group financing and guaranteeing arrangements are recognized for tax purposes. However, similar to PEs and head offices, while it is legally possible to assign risk to individual legal entities, economically, the creditworthiness of a particular group company tends to correspond with the creditworthiness of the multinational group of which it is part. Illustrative is the reality that group companies that finance their investments with debt may benefit from lower financing costs solely by reason of its affiliation with the group of which it is part ('passive association', see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, par. 7.13). The OECD nevertheless does not recognize a service provision in the benefits from being passively associated with the group, thereby assigning the synergy benefits in this respect to the respective subsidiary. Notably, US federal taxation shows evidence of adopting a similar approach, see 26 CFR 1.482-9(k)(3)(l)(3)(v) (passive association). The separate entity approach requires the taking into account of the perspective of the subsidiary on a stand-alone basis, though. That would, unless I am mistaken, call for the recognition for tax purposes of an intra-group service provision. Yet, as such an approach slopes away from economic realities, i.e., the multinational group as being one entity (unitary approach), in my view, the struggling of the OECD with multinational synergy benefits is illustrative for the conceptual problems in the use of separate accounting and arm's length pricing. This is further discussed hereunder. Notably, tax parity in line with economic reality may be achieved by consistently treating the multinational group as a single taxable entity, e.g., in a manner as discussed in Chapter 4.

[1374] As regards the absence of a tax parity in the treatment of multinational operations through permanent establishments and subsidiaries triggers the question whether the economic reality of the multinational group as one economic entity should be considered, e.g., as the OECD does regarding the permanent establishment and its head office in the area of notional financing and guaranteeing. Should a unitary approach also be adopted in respect of the intra-group legal realities? The OECD considers the diverging tax treatment not to be inconsistent or discriminatory by pointing at the legal differences between permanent establishments and group companies. However, in my view, the inconsistency, indeed, arises, as the legal differences are irrelevant from an economic perspective, since the intra-firm economic circumstances are identical. Both scenarios deal with a single economic entity, the multinational firm. The OECD's approach treats economically similar circumstances differently by pointing at the (economically irrelevant) intra-group legal differences. That constitutes a discriminatory tax treatment in my view.

[1375] Notably, with the term exploitation is meant the utilization for profit. Cf. Gordon V. Smith et al, *Valuation of Intellectual Property and Intangible Assets* (2000), at 333.

[1376] With respect to the attribution of debt and equity, the separate entity approach basically requires an equity allocation that is sufficient to bear the risks assumed in conjunction with the performance of functions and the use of assets by the respective entity. In the area of PE profit attribution, the OECD authorized some varieties in approaches in this area, e.g., the so-called 'capital allocation approach' and 'fungibility approach', as well as the 'capital allocation approach' and 'tracing approach' mentioned in the above. This is not further discussed. For some

The term 'significant people functions' aims at identifying the geographical location where the relevant people for the multinational firm's business operations perform their economic activities.[1377] Significant people are basically the firm's workers who actively make decisions on entering into the performed business operations, manage the risks involved in the business processes and utilize the firm's property. Significant people are those who are authorized, responsible and competent to perform the relevant functions in the business process.[1378] In addition, as the OECD considers that equity and debt capital follow the economic risks incurred, which for their part follow the functions performed,[1379] and as it considers that assets are to be allocated geographically to the taxing jurisdictions in which the significant people utilize them for the benefit of the firm's business operations – i.e., rather than where these assets are physically located –[1380] things boil down to the following nexus concept: *the profits are where the significant people are*.[1381]

This approach, economically, makes some sense, that is, to the extent that one pursues the objective of allocating business income to the state of origin. In a business environment, economic power, profit and value (today's worth of expected future profits) as well as the accompanying commercial risks tend to converge.[1382] Only the effective property owner may

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elaboration, see OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

[1377] See OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, and for some discussion Danny Oosterhoff, 'The True Importance of Significant People Functions', 15 *International Transfer Pricing Journal* 68 (2008).

[1378] See for instance the ruling of the Dutch Supreme Court in the so-called 'dividend mixer cases', Dutch Supreme Court, Nos. 37 652 and 40 586, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 2003/246, and Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 2008/255.

[1379] See OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at 91: *"capital follows risk"*. Moreover, the OECD, *idem*, at 70: *"risks follow the functions performed"*. Further, *idem*, e.g., at 72, the OECD sets forth that the property rights relating to *"assets follow the significant people"*. In addition to this, *idem*, at 57: *"profit follows functions"* (i.e., activities). Accordingly, the matter basically boils down to the discovering of the location of the significant people, as the profits should be there where these significant people perform their business functions. See for a comparison *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Chapter 1 at par. 1.45-1.49.

[1380] Accordingly, proceeds from distant manufacturing operations performed by utilizing mobile wireless ICT technologies, would, e.g., be assigned for tax purposes to the country where the significant people perform their functions. The exception to the rule is immovable property. The OECD Model Convention assigns the taxing rights with respect to income derived from the commercial exploitation of real estate consistently to the country in which the real estate is situated.

[1381] See OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at 24, par. 57: *"the approach is linking the earning of profit to the performance of functions equating functions to activities."*

[1382] See, e.g., Gordon V. Smith et al, *Valuation of Intellectual Property and Intangible Assets (2000)*. See also Lawrence Lokken, 'The Sources of Income From International Use and Dispositions of Intellectual Property', 36 *Tax Law Review* 233 (1980-1981),at 257, who refers to the association between ownership (power) and the rights to profit through the property's economic utilization. See further, OECD, *Discussion Draft; Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*, 6 June to 14 September 2012, OECD, Paris, 2012, reflecting on the pivotal role of the concept of control, at par. 41: *"Moreover where associated enterprises are retained to perform functions related to the development, enhancement, maintenance or protection of intangibles, it is expected that, in a situation where contractual entitlements and functions are in alignment, the party or parties claiming contractual entitlement to intangible related returns will exercise control over the performance of those functions and the associated risks, will bear the necessary costs required to support the performance of the function, and will provide arm's length compensation to any associated enterprise physically performing a relevant function.", and, at par. 54: "In summary, for a member of an MNE group to be entitled to intangible related returns, it should in substance, perform and control ..., bear and control …"* Further, see the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, on the matter at par 1.45: *"Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised."*, at par. 1.49: *"In arm's length transactions it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control."*, at par. 9.23 on business restructurings: *"In the context of paragraph 1.49, "control" should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people – employees or directors – who have the authority to, and effectively do, perform these control functions. Thus, when one party bears a risk, the fact that it hires another party to administer and monitor the risk on a day-to-day basis is not sufficient to transfer the risk to that other party."*, at par. 9.29: *"Another relevant, although not determinative factor that can assist in the determination of whether a risk allocation in a controlled transaction is one which would have been agreed between independent parties in comparable circumstances is whether the risk-bearer has, at the time when risk is allocated to it, the financial capacity to assume (i.e. to take on) the risk."*, at par. 9.39: *"In general, the consequence for one party*

exercise the bundle of ownership privileges, utilize them for the benefit of its business operations, make the decisions on the forms of commercial exploitation and investment, and effectively bears the risks involved. Control (i.e., regardless of the legalities), profit/loss, and value are inextricably linked. And, in the end, it is people who decide on business matters, not equipment or legal constructs. It is sometimes said that *"[t]he real measure of a company's value is now seen to rest on its people and technology-software ideas rather than its hardware equipment and real estate".*[1383] Accordingly, fundamentally, the origin of income refers to the human intervention or intellectual element as the quintessential component for actual wealth creation, recognizing income to originate where people actually perform economic activities. In view of the origin-based tax jurisdiction concepts that are present in the international tax regime, this is acknowledged to its fullest by the concept of 'significant people functions'.[1384]

6.3.3.4 'Significant people': all the multinational's employees, calling for 'labor factor presence test'

So, who are these significant people? Who should be identified as being 'significant'? The OECD refers to a spectrum of people functions ranging from support or auxiliary functions to significant functions relevant to the attribution of economic ownership of assets and/or the assumption of risk.[1385] It is the *significant* people we are looking for. While thinking of this, the picture of a Russian matryoshka doll comes into my mind. The quest for significant people seems to require a break-down of the functions performed into ever smaller sub-functions to be separately appraised at their fair market values in the subsequent allocation process. It seems that this would end up in assessing the activities undertaken by each individual worker. With respect to intangible asset creation, development and exploitation, the OECD refers to significant people as those involved in the active decision-making and management of the respective assets, i.e., the management below strategic level of senior management.[1386] Let us refer to the firm's 'middle management' in this respect, the intermediate executives.

Although I understand the pragmatics of this approach, it begs an answer to the question of whether the OECD *a contrario* considers people performing functions within the multinational other than 'significant people functions' to be 'insignificant', i.e., not to add value to the multinational firm. Should that be considered true? Do these 'insignificant' people, i.e., identified *a contrario* as the firm's upper management and lower management, as well as the operational workforce, not add value to the firm? Are they economically worthless? Insignificant? I would answer this question in the negative. First, this strikes me as odd, considering that management is also and simultaneously used in international tax to direct the

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of being allocated the risk associated with a controlled transaction, where such a risk allocation is found to be consistent with the arm's length principle, is that such party should: bear the cost … and generally be compensated by an increase in the expected return", and, at par. 9.41: *"risk carries profit potential"*. Finally, see, OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at par. 179: *"In arm's length dealings, it generally makes sense for parties to be allocated a greater share over risks over which they have relatively more control."*

[1383] See Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 6.

[1384] See for a comparison Eric C.C.M. Kemmeren, 'Source of income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach', 60 *Bulletin for International Taxation* 430 (2006). As the shifting of people functions accordingly entails the shifting of profits, this may explain the legislative efforts undertaken in German tax legislation to subject hidden reserves, i.e., the current worth of expected future earnings, to corporate tax upon the relocation of functions to abroad. See for some discussions on this matter Patrick Cauwenbergh et al, 'The New German Transfer Pricing Rules on Cross-Border Relocation of Functions: A Preliminary Analysis', 48 *European Taxation* 514 (2008), at 514-526, Peter H. Dehnen, 'Germany's New Transfer Pricing Rules on Transfers of Business Functions Abroad', 62 *Bulletin for International Taxation* 508 (2008), Heinz-Klaus Kroppen et al, 'Regulation on Business Restructuring: Decree-Law on the Relocation of Functions', 16 *International Transfer Pricing Journal* 63 (2009), Stephan Rasch et al, 'OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings', 2 *International Transfer Pricing Journal* 100 (2009), Stephan Rasch et al, 'OECD Guidelines on Business Restructuring and German Transfer of Function Regulations: Do Both Jeopardize the Existing Arm's Length Principle?', 18 *International Transfer Pricing* Journal 57 (2011).

[1385] See OECD, Centre for Tax Policy and Administration*, 2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at par. 62.

[1386] See OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at par. 87.

tax place of residence, and with that the entitlement to tax those profits that cannot be attributed to the permanent establishment abroad. Second, substantively, I would say that, as a multinational firm strives for profit maximization, every individual worker would need to be considered 'significant', i.e., in an academic sense of the language used. If a particular worker is non-productive, he does not do its work properly and therefore does not add value to the firm. In other words, if he is insignificant, I would assume that this worker would be let go. That is, under the assumption of the absence of labor market imperfections. For that reason and as a necessary consequence, every worker whose employment contract is not terminated apparently proves its significance.

As a result, seen from that perspective, the adoption of the concept of 'significant people functions' ends up establishing nexus within every jurisdiction in which the multinational has its worker(s) operational. This seems a fair position to take, as the OECD itself, for instance, sets forth that the active decision-making and management may often be devolved throughout the entire enterprise.[1387] Indeed, multinationals operate integrated global business enterprises. And if the rents are produced by the firm's workers, it seems to make sense to geographically localize corporate rents by geographically localizing its workforces; that is, under a supply-view income assignment. Yet, the presence of a workforce does not trigger the presence of a permanent establishment.

Notably, it is worth mentioning that it has been argued in tax literature that the concept of 'significant people functions' accordingly provides a profit sharing approach conceptually similar to some kind of payroll formulary apportionment ('payroll-FA'), i.e., the apportionment of corporate profit to taxing jurisdictions solely by reference to salaries and wages paid.[1388] To be honest, while recognizing the conceptual similarities, I am not sure whether that is actually the case. In international taxation, the 'significant people functions' concept constitutes a nexus expression. It does not say anything about the subsequent allocation process, i.e., the division of the overall corporate profit across tax jurisdictions. Payroll-FA, indeed, includes a nexus component similar to the concept of 'significant people functions' in international tax, as it seeks to identify the location where the workers exercise their employment contracts.[1389] However, payroll-FA proceeds by subsequently attributing corporate profit to taxing jurisdictions directly proportional to wages and salaries paid.[1390] This differentiates from the approach taken in international taxation. International tax, subsequent to the establishment of tax jurisdiction, e.g., by reference to the 'functional and factual analysis', proceeds to allocate corporate profits across countries, e.g., by reference to an endogenous evaluation of the relative contributions of significant functions performed. That is, converse to payroll-FA, it does not seek to attribute profits directly proportional to wage costs. It basically seeks to evaluate the significant workers' inputs at their fair value. Accordingly, only 'step 1' in international tax and payroll-FA analytically coincide. Kindly note that the German local trade tax ('Gewerbesteuer') levied by the German municipalities operates a payroll-only formulary system that geographically divides the trade tax regarding 'multi-municipal' business operations.[1391]

All in all, nexus at origin, indeed, may be identified, provided that the proper instrument is chosen out of the available alternatives. It seems that the instrument oriented to discovering *situs* most directly is the 'significant people functions'. Rather than utilizing the concepts of nationality, residence, or the old-fashioned 'permanent establishment' threshold, it may perhaps be worthwhile to just aim at geographically locating the multinational firm's workers for corporate tax nexus purposes.

[1387] See, e.g., OECD, *Addressing Base Erosion and Profit Shifting, OECD Publishing, 12 February 2013, at Chapter 3*

[1388] See e.g., Reuven S. Avi-Yonah et al, 'Formulary Apportionment – Myths and Prospects; Promoting Better International tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative', 3 *World Tax Journal* 371 (2011), at 393.

[1389] Reference is made to the payroll factors in formulary apportionment (United States, European Union CCCTB proposal) and formulary allocation (Canada).

[1390] Payroll-FA provides for a proxy. Empirical evidence suggests that payroll and corporate profit do not correlate directly proportionally. See James R. Hines Jr., 'Income misattribution under formula apportionment', 54 *European Economic Review* 108 (2010, No. 1), at 108-120.

[1391] See § 29 (Zerlegungsmaßstab) in conjunction with § 31 (Begriff der Arbeitslöhne für die Zerlegung) of the German Trade Tax Act (Gewerbesteurgesetz, GewStG). This is not further discussed. For some reading and analysis, see Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009).

Accordingly, the supply side of income basically and essentially seems to call for some alternative nexus concept that makes reference to the presence of workers within a tax jurisdiction. The taxable presence of multinational, e.g., could then be achieved by means of some quantitative 'labor factor presence test', which refers to, e.g., the operations undertaken by the multinational workforce within a country ('workforce presence test', or 'PE-when-functions-performed-rule') – subject to a *de minimis* threshold ('payroll State A exceeds amount €x').[1392] Some kind of an 'asset factor presence test', a 'debt and equity factor presence test', a 'capital factor presence test', or perhaps even a 'risk factor presence test', do not seem to be required as both capital and risk, as well as the assets used, follow the functions performed by the significant people – that is, the firm's workers.[1393] Let us proceed with allocation.

6.3.4 Allocation in international taxation, why SA/ALS fails

6.3.4.1 Allocation required to evaluate taxable presence

The second step in the process of geographically attributing multinational business income to taxing jurisdictions, subsequent to the identification of nexus and a taxable presence, is the evaluation of localized firm inputs. Multinational profits need to be divided geographically among the jurisdictions in which it is operational. But how?

The instruments used in international taxation for this purpose, both in respect of the attribution of profits to PEs and to affiliated entities, are the '(functionally) separate approach' or 'separate accounting' ('SA') and the 'arm's length principle' or the 'arm's length standard' ('ALS'). The SA/ALS methodology is commonly referred to as 'transfer pricing'.

However, unfortunately, SA/ALS seems destined to be inadequate to serve its designated purpose, both conceptually and pragmatically. SA/ALS fails to provide an objective instrument to allocate corporate profit inter-jurisdictionally. Let us assess why that is.

6.3.4.2 Transfer pricing: a world of 'smoke (SA) and mirrors (ALS)' causing the 'continuum price problem'

6.3.4.2.1 A 'universe of pretense'

Ultimately, to divide the multinational's total profit among the nation states involved, the international tax regime seeks to identify its relative contributions to the production of corporate profits within those states. The system accordingly aims at evaluating net value added at origin (*situs*).[1394]

The methodology generally used for this purpose, transfer pricing, is built on two fictions: the 'separate entity approach' and the 'arm's length standard'.[1395] The transfer pricing system

[1392] The approach taken in Article 15 OECD Model Tax Convention, perhaps, could provide some inspiration in designing such an alternative 'permanent-establishment-when-functions-performed-rule'.
[1393] Vleggeert, for instance, suggests to allocate the group's worldwide third-party debt by reference to its assets used, i.e., some kind of 'asset-factor debt allocation key'; see Jan Vleggeert, 'Interest Deduction Based on the Allocation of Worldwide Debt', 68 *Bulletin for International Taxation* 103 (2014), at 103-107. The US international tax system makes use of an assets based formulary mechanism to allocate interest expenses; see 26 CFR 1.861-9T – Allocation and apportionment of interest expense (temporary).
[1394] Cf. Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 712, Charles E. McLure Jr., 'Replacing Separate Accounting and the Arm's Length Principle with Formulary Apportionment', 56 *Bulletin for international taxation* 586 (2002), at 587, and Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275. Worth noting is that the SA/ALS standard may be considered a product of history rather than argument. See Stanley I. Langbein, 'The Unitary Method and the Myth of Arm's Length', 30 *Tax Notes* 625 (17 February 1986). Cf. 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).
[1395] See for a comparison, 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*

implicitly assumes that the apparent tax-independent constituent parts making up a multinational (SA), *'operating in concert, earn the same amount of income as would a group of unrelated entities operating in their own self-interests'* (ALS).[1396] However, this is not reality.

In reality, the multinational group operates as a single entity (see also Chapter 4),[1397] and its integrated business units share a joint interest, i.e., the objective of maximizing profit, the goal of generating infra-marginal returns. As transfer pricing accordingly defies reality, it has been referred to by commentators to operate in a 'universe of pretense', a mysterious *"world of smoke and mirrors"*,[1398] as in 'Alice's adventures in Wonderland', *"turning reality into fancy, pretending it to be the real world"*.[1399]

So, the international tax regime has created fictions to capture reality. That is not necessarily problematic. No problems would arise if the regime fulfills its task. Yet, the fictions created in tax cause a real-world problem: 'the continuum price problem'.

6.3.4.2.2 Fiction 1: The 'smoke' – multinational firm is single entity in reality, yet separate accounting (SA) in tax is the standard

Let us proceed, and, first, assess the 'smoke' (separate accounting; SA). In today's globalizing economy, multinationals operate as a single economic entity for the purpose of maximizing its rents on a global scale.[1400] The multinational business operations are functionally integrated, typically both vertically and horizontally.[1401] That is regardless of

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Taxation 196 (2004), and Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275. See for some details of the historical origins of the arm's length standard Stanley I. Langbein, 'The Unitary Method and the Myth of Arm's Length', 30 *Tax Notes* 625 (17 February 1986), and Hubert M.A.L. Hamaekers, 'Arm's Length - How Long?', 8 *International Transfer Pricing Journal* 30 (2001), at 30.

[1396] Cf. Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 277. See also Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 7.

[1397] Notably, in Chapter 4, I advocate taxing multinational firms as a single taxable entity by means of tax consolidation. See for a comparison Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 178: *" (…) rationale for taxing affiliated companies on a consolidated basis is acknowledging the fact that taxing businesses on a separate entity approach artificially divides up the profits earned by unitary enterprises."*

[1398] See e.g., Michelle Markham, *The transfer pricing of intangibles* (2005), quoting R.J. Misey Jr. at 23.

[1399] See Jerome R. Hellerstein, 'Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment', 60 *Tax Notes* 1131 (23 August 1993), at 1136-1145. See further Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation', *University of Michigan Law School*, *John M*, *Olin Center for Law & Economics*, Working Paper No. 07-017 (2007), arguing that the arm's length standard does not reflect economic reality. Cf. Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 832.

[1400] See for a comparison Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 264: *"Indeed, without much exaggeration, one might define the multinational as a legal structure for obtaining economic rents on a global scale, particularly marketing rents and rents from intangible property."* Further, cf. Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation', *University of Michigan Law School*, *John M*, *Olin Center for Law & Economics*, Working Paper No. 07-017 (2007). See also Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', 62 *Bulletin for International Taxation* 201 (2008), at 203 and David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 1: The Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 55 (2004), at 57. Further, see Stanley I. Langbein, 'The Unitary Method and the Myth of Arm's Length', 30 *Tax Notes* 625 (17 February 1986), at 657, who sets forth that the affiliates of a multinational do not necessarily treat other affiliates as wholly separate corporations. Further see Jerome R. Hellerstein, 'Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment', 60 *Tax Notes* 1131 (23 August 1993), at 1136-1145. Worth noting is OECD, *Discussion Draft; Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*, 6 June to 14 September 2012, OECD, Paris, 2012, at par. 83, reflecting an implicit appreciation by the OECD of the multinational's common profit motive: *"… is consistent with the assumption that MNE groups seek to optimize resources allocations, at least on an after tax basis."*

[1401] Notably, vertical integration occurs when a multinational engages into two or more primary economic activities within the same value chain (e.g., manufacturing and distribution of a product or product line). Horizontal integration occurs when a multinational engages into economic activities within two or more value chains (e.g. manufacturing and distribution of two or more products or product lines). See for some discussion David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 1: The Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 55 (2004), at 58.

whether the firm operates its business enterprise through a branch structure or a subsidiary structure.[1402]

However, in taxation, multinationals are deemed to be segregated into (functionally) separate entities for profit allocation purposes, able to enter into internal tax-recognized arrangements. Legal entities and permanent establishments are deemed to operate on a stand-alone basis in this respect, (functionally) separate from the multinational firm from which they are an integral part, i.e., the concept of the '(functionally) separate entity' or 'separate accounting'.[1403] Separate entities that are part of a functionally integrated multinational firm are referred to as 'associated enterprises'.[1404] Companies and corporations typically even constitute single taxpayers for corporate tax purposes (see also Chapter 4). As a consequence, dealings and legal transactions internal to the firm are recognized for tax allocation purposes. These constitute a taxable event. This 'transactional approach' entails a break-down of the aggregate of internal relations within an integrated group into a multitude of separately distinguished transactions.[1405]

Accordingly, the concept of separate accounting constitutes 'fiction 1', the 'smoke', since, in reality, multinationals are not functionally segregated. Worth noting is that the OECD also refers to the 'functionally separate entity approach' for PEs as a 'mere fiction'.[1406] Economically, the same is true for the utilization of the 'separate entity approach' for affiliated entities.[1407] The (functionally) separate entity approach for both PEs and group companies initiates a fictitious turn of events. It entails the recognition of intra-group legal reality for tax allocation purposes, devoid of economic ratios, and hence, a fiction as well.[1408] As will be shown, this lies at the heart of the issues that have emerged.[1409]

6.3.4.2.3 The consequence: a potential for arbitrage

In a cross-border context, the recognition of intra-firm legal realities for tax allocation purposes triggers a potential for arbitrage: 'paper profit-shifting'.[1410] As the various sub-units

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[1402] Cf. 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 199, and Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275.

[1403] Cf. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Preface at par. 5, as well as at par. 1.6, as well as OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at 8-11.

[1404] The OECD Model Tax Convention considers enterprises to be associated where *a*) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State (e.g. parent and subsidiary), or where *b*) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State (e.g., 'sister' companies). See Article 9(1) OECD Model Tax Convention. For some reading and analysis, see Ramon S.J. Dwarkasing, 'The Concept of Associated Enterprise', 41 *Intertax* 412 (2013), at 412-429.

[1405] See for a comparison 26 CFR 1.482-1(b)(2)(ii) in conjunction with 26 CFR 1.482-1(f)(2)(i) (Aggregation of transactions).

[1406] See OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at par. 11 and 176.

[1407] Interestingly, the OECD considers the opposite to hold for group companies. In its Report on the Attribution of Profits to Permanent Establishments, the OECD refers to the separate entity approach for subsidiaries as reality. See OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at par. 13 and 176. Contra OECD, *Addressing Base Erosion and Profit Shifting, OECD Publishing, 12 February 2013,* as the OECD considers the multinational to constitute a single entity at 25.

[1408] See Jerome R. Hellerstein, 'Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment', 60 *Tax Notes* 1131 (23 August 1993), at 1136-1145.

[1409] See also Sol Picciotto, 'Transfer pricing is still dead ... From Independent Entity Back to the Unitary Principle', 73 *Tax Notes International* 13 (6 January 2014), at 13-18.

[1410] Cf. Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 7: *"… it is well known that the SA methodology gives MNEs scope for strategic tax planning and tax avoidance, to the detriment of collection of public revenues. In particular, the current arm's length-based system for multinational groups to shift taxable profits between each Member State provides possibilities for multinational groups to shift taxable profits between the different EU countries in which they operate (ie, by strategically manipulating the internal transfer prices of their intra-group transactions or by altering the financial structure of the group members in order to minimize the groups' overall tax liabilities) This causes tax-induced distortions to the international allocation of corporate tax bases across EU*

(subsidiary or branch) of the multinational firm that are deemed functionally segregated for tax allocation purposes in fact are functionally integrated, the tax recognized intra-firm transactions and dealings are not founded on real world third-party market factors.[1411]

In a third-party business environment, the agreed prices and contractual terms underlying the provisions of products and services are the outcome of a bargaining process in which the parties involved have opposing economic interests. The established value of the transaction lies outside the control of the individual parties entering into it. This makes it feasible for tax allocation purposes to rely on the legalities in this regard, as these are the outcome of a third-party bargaining process. In such a third-party business environment, the mutually opposing economic interests of the parties involved constitute the market forces that drive the fair market value of the property transfer.[1412] In such a case, legalities and fair market value may fairly be considered to match. Aggressive tax planning operations, for instance, typically do not occur outside the controlled environment within the functionally integrated multinational firm.[1413] With respect to third-party transactions, it may be argued that a sufficient 'self-policing mechanism' exists in the form of the opposing underlying economic interests that drive third-party market transactions in a competitive business environment.[1414]

In an intra-firm environment, however, such opposing economic interests are absent. Here, the market forces are directed differently. They converge, as the multinational and its functionally integrated parts share a common economic interest: the optimization of the combination's after-tax economic rents.[1415] As a consequence, the internal transfer prices of intra-firm transactions and dealings are of no commercial significance to the multinational firm, since it merely reallocates taxable profit internally.

As a result, the recognition of intra-firm transactions and dealings for tax allocation purposes provides an incentive to the multinational firm. The transactional approach affects the volumes of taxable profits realized by the segregated parts of the firm in the jurisdictions in which they are active. Furthermore, corporate tax constitutes a cost from a micro-business economics perspective. Consequently, the common objective of optimizing multinational after-tax profits triggers the associated enterprises involved to utilize the (functionally) separate entity approach for their benefit and strategically set the transfer prices for intra-firm provisions of goods and services. That is, for the purpose of subsequently shifting taxable

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countries and is an additional reason for tax competition among national governments (further than the traditional tax competition for real investment), as identified by recent literature)…"

[1411] Cf. Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 825. See also *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 1.2: *"When independent enterprises transact with each other, the conditions of their commercial and financial relations (e.g. the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces. When associated enterprises transact with each other, their commercial and financial relations may not be directly affected by external market forces in the same way,"* and, for a comparison, at par. 9.13 regarding the transfer pricing of business restructurings (i.e., for transfer pricing purposes defined as the cross-border redeployment by a multinational enterprise of functions, assets and/or risks; *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, par. 9.1. Further, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, par. 9.48: *"A business restructuring may involve cross-border transfers of something of value, e.g. of valuable intangibles, although this is not always the case. It may also or alternatively involve the termination or substantial renegotiation of existing arrangements, e.g. manufacturing arrangements, distribution arrangements, licenses, service agreements, etc."*

[1412] Cf. Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 547. The fair market value of property may be defined as: *"the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts and with equity to both (i.e., the exchange will be fair and neither will gain advantage in negotiation or in the terms of sale)."* See for a comparison Gordon V. Smith et al, *Valuation of Intellectual Property and Intangible Assets (2000)*, at 156, and William P. Elliot, 'Development, Ownership and Licensing of Intellectual and Intangible Properties – Including Trademarks, Trade Names and Franchises', *Taxation of Corporate Transactions* 21 (2004), at 50.

[1413] See for a comparison Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 177, and Benjamin F. Miller, 'None Are So Blind as Those Who Will Not See', 66 *Tax Notes* 1023 (13 February 1995), at 1030.

[1414] Cf. Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38, Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 177, and Benjamin F. Miller, 'None Are So Blind as Those Who Will Not See', 66 *Tax Notes* 1023 (13 February 1995), at 1030.

[1415] Cf. Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', 62 *Bulletin for International Taxation* 201 (2008), at 201.

earnings and profits to the relatively low-taxing jurisdictions and deductible expenses and losses to the relatively high-taxing jurisdictions.

The arbitrage potential as made available obviously begs to be employed as a tool to shift taxable profit to reduce the global AETR. It is no secret that strategic transfer pricing arrangements are set up by multinationals as a means to achieve this exact purpose.[1416] Note that key for the arbitrage potential is that the market forces driving the values of transactions in an intra-firm environment differ from those in a third-party business environment.

6.3.4.2.4 Fiction 2: The 'mirrors' – arm's length standard (ALS) in tax to counter arbitrage potential created, yet in reality firm derives rents

In international tax, the arbitrage is sought to be resolved through the introduction of a second fiction: the arm's length standard ('ALS') – the 'mirrors'. For tax allocation purposes, it has been deemed that the tax-recognized intra-firm transactions undertaken by the parts of the firm that are deemed functionally segregated are driven by third-party market forces.[1417] It is hypothesized that associated enterprises set their transfer prices *as if* they are unaffiliated. Accordingly, the charging for the provision of goods or services by one segment of the firm to another segment of the same firm occurs by reference to a third-party equivalent. What would a third-party do? The ratio underlying the arm's length standard is to promote the tax parity of affiliated and unaffiliated taxable corporate entities.[1418] Accordingly, SA/ALS seeks to tax-treat different economic circumstances on par, and, hence, implicitly promotes inequity and the non-neutrality of legal form.[1419]

The benchmark utilized to obtain the arm's length transfer price (or range of arm's length prices)[1420] is the comparable price (or range of prices) for a comparable transaction as would be undertaken by third parties in comparable circumstances.[1421] For this purpose, a comparison is made between the controlled transfer price and the uncontrolled 'third-party price' or 'third-party range'.[1422] The assessment undertaken in the quest to determine the fair market value(s) of the intra-firm transaction(s) is referred to as the third-party 'comparability analysis'.[1423] In practice, the analysis is generally performed by reference to profit level indicators found in publicly available financial data (annual accounts, reports, et cetera),

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[1416] See Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation', *University of Michigan Law School*, *John M*, *Olin Center for Law & Economics*, Working Paper No. 07-017 (2007), and 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 199, as well as Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275.

[1417] Cf. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Preface at par. 6, as well as par. 1.6.

[1418] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 1.8. Cf. U.S. Regulations, 26 CFR 1.482-1(a)(1).

[1419] See Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 713. Devereux argues that the placing of a controlled taxpayer with an uncontrolled taxpayer on a tax parity entails inequality. He further sets forth that the required treatment of intra-group transactions by making reference to outsourced equivalents induces a distortion of the choice of organizational form and in the level of investment undertaken.

[1420] On arm's length price ranges, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at 3.63-3.66. See also 26 CFR 1.482-1(e).

[1421] Cf. Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 830.

[1422] Transactions are typically considered comparable if none of the differentials could materially affect the factor being examined in the methodology (e.g. price or margin) or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

[1423] For the purpose of determining the comparability of the intra-firm transaction with a third-party transaction, the OECD forwards its 'five factors of comparability': (1) the specific characteristics of the property or services being purchased or sold; (2) the functions performed by the parties to the transaction (taking into account assets used and risks assumed); (3) the contractual terms and conditions employed; (4) the economic circumstances of the parties involved, and; (5) the business strategies pursued by the parties. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at section D.1.2 and Chapter III. See also OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at par. 183 and 189-194. The US adopts similar comparability factors in its Section 482 Treasury Regulations, see 26 CFR 1.482-1(d).

commonly made accessible and manageable via commercial databases.[1424] The primary burden of establishing the arm's length nature of the reported taxable profit is typically passed on to the taxpayer, i.e., profit allocation is a 'DIY-affair'.[1425]

To the extent that associated enterprises are not considered to set their prices at arm's length, the taxable profits realized accordingly are adjusted to an arm's length standard. The non-businesslike transfer price is adjusted to a businesslike transfer price. To achieve single taxation, a transfer pricing adjustment in one state may be followed by a reverse adjustment in the other state (i.e., the 'corresponding adjustment').[1426] Administrative procedures are typically available as a means to this end (mutual agreement procedures or sometimes arbitration procedures).[1427] The final allocated profit is the result of offsets among the whole body of intra-group transactions.

In reality, however, as said, intra-firm modes of transfers are not driven by third-party market forces. ALS hypothesizes a market environment that is opposite to business economics realities. It neglects that there is a commercial reason for a multinational firm to decide to keep certain economic activities in-house, rather than to outsource them to a third-party. That is, as the firm strives for profit optimization, that decision would be the more profitable one. ALS essentially requires answering the question *"what would have happened if the ownership link had been absent and the respective entity was motivated by its own economic interest?"*[1428] But in reality, the ownership link is present and the multinational's business units are motivated by the shared economic interest of deriving economic rents for the benefit of the multinational firm. ALS feigns a market which actually is not there, i.e., 'fiction 2', accordingly. Perhaps, it is not that surprising that SA/ALS is incapable of yielding sensible results.[1429]

6.3.4.2.5 The consequence: the 'continuum price problem'

The stacking of fictions renders the system broken

[1424] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Chapter III, section A.4.3.

[1425] Typically, for tax administration purposes, MNEs are required to comply with strict documentation requirements, requiring them to carefully monitor, substantiate and administer the intra-group transactions undertaken. Accordingly, while it is the states involved that are primarily interested in taxing their share of multinational profits, it is the multinational that is the first to substantiate the appropriate transfer price. For some comments on the division of the burden of proof in transfer pricing and documentation requirements, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at Chapters IV (par. 4.11-4.17) and V. See also OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at par. 224-226.

[1426] See Article 9(2) OECD Model Tax Convention. For some further comments on corresponding adjustments, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at Chapter IV, par. 4.32-4.39.

[1427] Mutual agreement procedures under Article 25 OECD Model Tax Convention may for instance lead to bi-/multilateral advance pricing agreements (so-called 'MAP-APAs'). See for some comments on the mutual agreement procedure *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at Chapter IV, par. 4.29-4.31. On administrative approaches to avoid and resolve transfer pricing disputes forwarded by the OECD, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at Chapter IV, par. 4.166-4.168. Notably, within the European Union, the European Union Arbitration Convention applies, enabling taxpayers to bring transfer pricing issues before an arbitration court issuing a binding resolution. Many double tax conventions make arbitration available. To the extent that they do not, the states involved are not legally required to reach agreement on the transfer prices set. Double (non-)taxation may be the consequence – as was for instance the case in the infamous $3.4 billion GlaxoSmithKline settlement.

[1428] Cf. 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 249 and Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286. See also Steve Christensen, 'Formulary Apportionment: More Simple – On Balance Better', 28 *Law and Policy in International Business* 1133 (1996-1997), at 1136.

[1429] Cf. Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines A Proposal for Reconciliation', 2 *World Tax Journal* 3 (2010), at 5. See also Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 8.

The stacking of fictions in taxation has an unfortunate real-world consequence. It creates the so-called 'continuum price problem', rendering the SA/ALS-system broken.[1430] As said, SA/ALS deems the segregated parts of the multinational to earn an equivalent amount of income as would a group of unrelated entities, motivated by their own commercial interests. However, *"[t]he multinational firms did not come to dominate international markets by earning the same profits as their local competitors".*[1431] Multinationals derive economic rents, excess earnings, which explains not only their presence in the market, but their survival in a competitive business environment as well. The key problem with SA/ALS is its incapability to properly account for these rents.

SA/ALS would perhaps work in a fictitious world of perfect competition without specialty products. In such an environment, it would be immaterial whether activities are outsourced or kept in-house. General profit maximization theory suggests that marginal returns in such a case diminish and end up at zero (i.e., profit reaches its maximum point where marginal revenue equals marginal cost). Further, the intuition is that as long as profit-making possibilities are available, competitors will enter the market to provide comparable products and services. That would push down prices until the point of equilibrium where the profit is nil.[1432]

Accordingly, that would imply that in such a fictitious world the SA/ALS-system would ultimately produce transfer prices set at cost, i.e., without a profit mark-up. In theory, such a pricing without a mark-up would not be problematic, as no marginal profits would be made. Interestingly, that would also imply that corporate tax would end-up being abolished, as marginal profit would simply diminish.[1433] In such a world without profits, there would be no need for profit taxation. *A fortiori*, a profit division mechanism would be redundant as well. SA/ALS would work in a world without the need to split profits among jurisdictions. Furthermore, in such a world multinationals operating integrated businesses would not exist. Viz., as there would be no room for economic rents – the key driver behind the real-world emergence of multinationals – there would be no need to functionally integrate business.[1434] Tragically, the fictitious world of SA/ALS would only work in a fictitious world of perfect competition where profit is nil.

Internalization theory: keeping matters in-house is more profitable

In reality though, there is no perfect competition. The very reason that multinationals exist boils down from the commercial benefits available from economic integration relative to

[1430] To the best of my knowledge, the term has been mentioned first by Langbein. See Stanley I. Langbein, 'The Unitary Method and the Myth of Arm's Length', 30 *Tax Notes* 625 (17 February 1986), at section 3. Langbein provides for some US tax case law to substantiate his thesis. He also addresses the potential for promoting (or at least tolerating) undertaxation effects as a consequence of the matter. Cf. Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation', *University of Michigan Law School, The John M. Olin Center for Law & Economics Working Paper* 2007:73, who refers to the created taxable profit shifting opportunities as a consequence of this. See also Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 15. See further Hubert M.A.L. Hamaekers, 'Arm's Length - How Long?', 8 *International Transfer Pricing Journal* 30 (2001), at 34, Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 832 and 840, as well as Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', 62 *Bulletin for International Taxation* 201 (2008), at 206, David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 1: The Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 55 (2004), and Erik Röder, 'Proposal for an Enhanced CCTB as Alternative to a CCCTB with Formulary Apportionment', 4 *World Tax Journal* 125 (2012), at section 2. See also Steve Christensen, 'Formulary Apportionment: More Simple – On Balance Better', 28 *Law and Policy in International Business* 1133 (1996-1997), at 1159. Also the OECD refers to this argument. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 1.10.

[1431] Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 277.

[1432] See Charles E. McLure, Jr., 'The State Corporate Income Tax: Lambs in Wolves' Clothing', in Henry J. Aaron et al (eds.), *The Economics of Taxation* (1980) 327, at 334: *"… in competitive industries there are no economic profits except as a transitory phenomenon."*

[1433] See for some further analysis, see Ruud de Mooij, 'Will corporate income taxation survive?', 3 *De Economist* 153 (2005).

[1434] Cf. Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 834, who refers to the presence of synergy rents as the very raison d'être of the multinational firm.

market transactions.[1435] Multinationals internalize business activities to avoid the costs that arise due to market inefficiencies (i.e., transactional costs, costs of mutual trust issues and risk management) that are apparent to third-party dealings.[1436] Multinational integration occurs to obviate these hazards external to the firm, e.g. quality control, security of information, and reputational issues. It is the common control through which these risks are managed. Multinationals are able to reduce costs through synergy by accordingly taking advantage of economies of scope and scale.[1437] The ability to avoid (internalize) transaction costs lies at the heart of the firm's structure. It provides multinationals economic advantages and sources of profitability.

The cost of market imperfections are minimized where interdependent business is brought under common ownership and control. Multinationals accordingly arise where business integration through control mechanisms offers advantages over entering into market transactions, i.e., the 'theory of the firm', or 'internalization theory'.[1438] Within the multinational enterprise, market transactions are eliminated and replaced by the entrepreneur coordinator. Effectively, this entails the supersession of the price mechanism as costs savings from internalizing business.[1439] Indeed, there is a commercial reason for keeping certain activities in-house: it is more profitable.

Firm specific rents due to specialty products

Further, and perhaps even more substantial, firms provide specialty products in the real-world. There is another reason why multinationals have thrived in a competitive market environment and have come to dominate cross-border trade and investment in today's globalizing marketplace. They gain their competitive advantages relative to their competitors by providing unique products and services allowing them to generate excess earnings.[1440]

[1435] Cf. Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines A Proposal for Reconciliation', 2 *World Tax Journal* 3 (2010), at 5.

[1436] Cf. 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 239 and Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286. See also Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 8-9.

[1437] See also Hubert M.A.L. Hamaekers, 'Arm's Length - How Long?', 8 *International Transfer Pricing Journal* 30 (2001), at 34. Further see Richard M. Bird, 'Shaping a New International Tax Order', 42 *Bulletin for International Fiscal Documentation* 292 (1988), at 292-299. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, respectively at par. 9.1. and 9.57 on the commercial rationales for business restructuring: *"Since the mid-90's, business restructurings have often involved the centralisation of intangible assets and of risks with the profit potential attached to them,"* and: *"Business representatives who participated in the OECD consultation process explained that multinational businesses, regardless of their products or sectors, increasingly needed to reorganize their structures to provide more centralized control and management of manufacturing, research and distribution functions. The pressure of competition in a globalised economy, savings from economies of scale, the need for specialization and the need to increase efficiency and lower costs were all described as important in driving business restructuring."* Cf. Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 5, and Patrick Cauwenbergh et al, 'The New German Transfer Pricing Rules on Cross-Border Relocation of Functions: A Preliminary Analysis', 48 *European Taxation* 514 (2008), at 514, referring to the *"stripping out"* of functions.

[1438] The theory of the firm has been developed by Coase. See Ronald H. Coase, 'The Nature of the Firm', 4 *Economica* 386 (1937), at 386-404 and Ronald H. Coase, 'Lectures on the Firm', 4 *Journal of Law, Economics & Organizations* 3 (1988), at 3-47. Langbein also refers to Coase's theory of the firm to establish his 'price continuum problem'. See Stanley I. Langbein, 'The Unitary Method and the Myth of Arm's Length', 30 *Tax Notes* 625 (17 February 1986), at 666-667. Cf. Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 832-833. See also 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, as well as Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286.

[1439] Notably, David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 1: The Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 55 (2004), at 58 refers to the benefits of integration as the 'OLI paradigm', i.e., the generally accepted microeconomic rationale for the emergence and international commercial successes of MNEs compared to independent enterprises by making reference to the advantages of available 'Ownership', the advantages of available alternative 'Locations' for production and the advantages of 'Internalization'.

[1440] See Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 832 who refers to residual profits in this respect.

The novelty element is recognized at least in the eyes of the modal customer who is loyal to the product. It is the novelty item that explains why customers stand in line and keep coming back to buy that particular tablet, apparel, or the soft drink of that particular brand.[1441] This allows multinationals to derive their firm specific rents.[1442] Firm specific rents may be present either on the supply side of income or on the demand side of income; they do not have a definite geographic location.[1443]

The novelty product, the innovative advantage that is responsible for the rent-production is generally driven by the multinational firm's underlying high-worth intangible assets such as brands or patents. These effectively place the multinational in a monopoly position, with the sole right of commercial exploitation. It is that unique element that enables the multinational to drive actual arm's length competitors out of the market.[1444] *"Only companies that have valuable intangibles can actually offer unique products and services and thus can escape the continuing process of price erosion".*[1445] *"The competitive atmosphere of the global marketplace has compelled multinationals to focus on continuous innovation, achieved by means of massive investment in intangible assets. A further contributing factor to this surge in the importance of intangibles in global trade is the rise of information technologies, especially the internet.[1446] Investment in intangibles has thus become a fundamental source of continuing profitability and increased market share of leading international corporations."*[1447]

SA/ALS neglects internalization theory and novelty items, thereby leaving the residual uncalled for

The 'continuum price problem' in SA/ALS comes to light. SA neglects the internalization theory. It ignores the differences between market transactions governed by market forces and intra-group transactions governed by control mechanisms.[1448] ALS also neglects the novelty element. [1449] By relying on external comparables, it ignores that multinationals actually derive their rents through the commercialization of intangibles provided by a monopoly for which no comparables exist.

In consequence, the sum of the stand-alone returns of the separate associated entities as determined in accordance with SA/ALS differs from the profit of the multinational group as a whole. SA/ALS accordingly is incapable of accounting for the economic benefits that have led to the emergence of the multinational in the first place. The difference may be explained in various terms, for instance, the 'residual', the 'synergistic benefits of internalization', the

[1441] See for a comparison Yariv Brauner, 'Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes', 28 *Virginia Tax Review* 81 (2008).
[1442] Cf. Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 265: *"In the real world of imperfect competition, multinational enterprises have flourished through their ability to exploit what are commonly called economic rents. (…) They may be described as a type of intangible property that allows the holder to extract profits above the average return on capital. Economists often detect the existence of economic rents by observing that above-average profits are being earned. In this respect, economic rents serve a function for economists that is analogous to the function that goodwill serves for accountants. That is, the rent is a residual asset that explains why profits are greater than might otherwise be anticipated by economic theory."*
[1443] Cf. Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), and Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 265.
[1444] Cf. Reuven S. Avi-Yonah, 'The Structure of International Taxation: A Proposal for Simplification', 74 *Texas Law Review* 1301 (1996), at 1343. See also Monique van Herksen et al, 'Identifying, valuing, and migrating intangibles: trouble ahead', TPI Transfer Pricing, May 2008: *"intangibles are by definition unique".*
[1445] See Fred C. de Hosson, 'Multinational Enterprises and the Development, Ownership and Licensing of Trademarks and Trade Names', 11 *Intertax* 398, at 398.
[1446] See Michelle Markham, *The transfer pricing of intangibles* (2005), at Chapter 1.
[1447] See Michelle Markham, 'Tax in a Changing World: The Transfer Pricing of Intangible Assets', 40 *Tax Notes International* 895 (5 December 2005), at 895-906.
[1448] Cf. Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 832, and 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 198, as well as Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286.
[1449] See Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 832 referring to residual profits in this respect.

'multinational efficiency premium',[1450] or the 'economic rents'. These firm specific benefits are unavailable to unaffiliated parties dealing on an arm's length basis. The difference constitutes the return to the entrepreneurship of the entrepreneur coordinator, the marginal product of the entrepreneur, its 'infra-marginal return'.[1451] That is, the remuneration for the production factor of enterprise.[1452]

Arbitrage and controversy as a consequence

The theoretical deficiency translates in practice into arbitrage, controversy, enforcement deficits and compliance issues.[1453] Unable to account for the residual, SA/ALS arbitrarily and thereby inherently subjectively assigns it to one part or certain parts of the economic entity, i.e., the 'continuum price problem'. Particularly, the one-sided 'transaction-based transfer pricing methods' – see hereunder – fall short of providing meaningful guidance to answer the question of how to allocate the multinational efficiency premium.[1454] This provides multinationals some leeway in assigning the residual to any designated part of the firm at their discretion and thereby to the (low-)taxing jurisdiction. That is, in tax, the residual is mobile. Accordingly, SA/ALS may be considered to promote undertaxation.[1455] Even the OECD acknowledges that there are *"no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises"*.[1456] Obviously, tax authorities may want to warrant their share of multinational earning power. They may not be willing to see the residual left untaxed. Not surprisingly, this may trigger controversies and

[1450] See David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 1: The Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 55 (2004), at 61.
[1451] See Ronald H. Coase, 'The Nature of the Firm', 4 *Economica* 386 (1937) and Ronald H. Coase, 'Lectures on the Firm', 4 *Journal of Law, Economics & Organizations* 3 (1988).
[1452] See for a comparison the ruling of the U.S. Supreme Court in *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 228, at 222-223, 100 S. Ct. at 2109 (1980), where the court noted that: *"separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale"* (…) Since such factors arise *"from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.'"* Cf. Jerome R. Hellerstein, 'State Taxation Under the Commerce Clause: the History Revisited', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 53, at 67.
[1453] See for a comparison Reuven S. Avi-Yonah et al, 'Formulary Apportionment – Myths and Prospects; Promoting Better International tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative', 3 *World Tax Journal* 371 (2011), at 379.
[1454] See David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 1: The Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 55 (2004), at 74. Francescucci argues that the application of one-sided transfer pricing methods does not account for the synergistic benefits of internalization with the result that the excess profit is allocated to the jurisdiction other than that of the tested party. See for a comparison, OECD, *Revised discussion draft on transfer pricing aspects of intangibles*, 30 July 2013, OECD, Paris, 2013, at par. 130: *"A one-sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving intangibles."* Cf. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 6.14: *"Arm's length pricing for intangible property must take into account for the purposes of comparability the perspective of both the transferor of the property and the transferee."* Another example is the geographical allocation of the benefits of passive association. That is, the economic benefit of a lower interest rate being charged to an enterprise upon the financing of a certain investment with debt (say, a rate charged of 7%), due to that enterprise being part of a multinational group rather than it standing alone (say, rate charged of 10%). The benefit (of in this case 3%) is attributed to the operational group company. That is, since the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 7.13, does not recognize a service intra-firm service arrangement. Would the OECD recognize a service granted to the operational subsidiary for which an arm's length remuneration should be charged, the benefits of being passively associated with the multinational group would be distributed to the parent company or perhaps assigned in a certain pro rata parte manner among the multinational group entities. Only an explicit guarantee (e.g., from the parent company, further reducing the rate charged to the subsidiary to, say 5%) constitutes an intra-group service rendered for which a fee should be charged (in this case of, say, max. 2% payable by the subsidiary to the parent company). See on this matter also OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Guidance on Transfer Pricing Aspects of Intangibles*, Paris, 16 September 2014. Notably, the US adopts a similar approach, see 26 CFR 1.482-9(k)(3)(l)(3)(v) (passive association).
[1455] See for a comparison Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 253. See also Michael Mazerov, 'Why arm's length falls short', 5 *International Tax Review* 28 (1994), arguing at 28-32, that this *"costs the federal and state treasuries billions of dollars annually in unjustified and unnecessary revenue losses: a public policy failure that borders on the scandalous"*, and *"creates inequities in tax payments and thereby tilts the competitive playing field by allowing global corporations to play transfer pricing games that entirely domestic firms are not even eligible to enter"*.
[1456] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 1995, at par. 1.9.

disputes between multinationals and tax authorities, as well as controversies among the tax authorities of the countries involved (the latter, notably, sometimes even at the expense of the taxpayer). Enforcement and compliance issues, legal uncertainties, and double (non-)taxation, may be the inevitable consequence.[1457] The subjective nature of determining an appropriate arm's length profit makes it virtually impossible to forecast the outcome in substantive terms of any transfer pricing discussion.[1458]

The problems in practice typically center on intangible asset commercialization.[1459] This may be explained as follows. Asset ownership provides the owner a monopoly right to commercially exploit it. It is that exclusivity privilege that secures the property's commercial value.[1460] Further, the exclusivity entitlement essentially renders the required quest in transfer pricing to explore and collect external data on comparables conceptually pointless.[1461] Notably, this holds true also for the exclusive exploitation rights relating to commonly available routine (in)tangible assets. However, these do not trigger that many controversies in practice. This may be explained by acknowledging the relatively limited economic interests involved. Routine items are typically not of much value to the firm. Note further that this may also explain why, in practice, the desired taxable arm's length mark-up may sometimes be established upfront and substantiated subsequently via a 'smoke and mirrors' benchmark analysis performed by a transfer pricing specialist (c.q. wizard).[1462]

[1457] See Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation', *University of Michigan Law School*, *John M*, *Olin Center for Law & Economics*, Working Paper No. 07-017 (2007), who refers to the created climate of legal uncertainty and huge administrative burdens for taxpayers, tax authorities and tax courts. See also Hamaekers refers to the heavy administrative burdens that result from the essential role of comparables; Hubert M.A.L. Hamaekers, 'Arm's Length - How Long?', 8 *International Transfer Pricing Journal* 30 (2001), at 36, Michael Mazerov, 'Why arm's length falls short', 5 *International Tax Review* 28 (1994), arguing at 28-32 that this *"diverts too many scare resources both public and private, to tax planning, complex accounting and auditing practices, and lengthy litigation"*, and *"fails to guarantee any substantial degree of international uniformity in the division of income for tax purposes,"* and Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 271-272: *"Transfer-pricing rules are extremely complex, to the point, perhaps, of being incapable of fair administration. They are also easy to manipulate, for their operation depends on factual matters typically under the control of the taxpayer. In addition, the rules are not uniform. Many different arm's-length pricing methods are arguably applicable to the same set of transactions."* On administrative approaches to avoid and resolve transfer pricing disputes forwarded by the OECD, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at Chapter IV.

[1458] See for a comparison Steve Christensen, 'Formulary Apportionment: More Simple – On Balance Better', 28 *Law and Policy in International Business* 1133 (1996-1997), at 1158. Further, see Michael Mazerov, 'Why arm's length falls short', 5 *International Tax Review* 28 (1994), at 28-32, referring in this respect to an *"audit roulette"*, which explains *"why the federal government and national governments are suffering massive revenue losses under the current system and why cases can drag on for a decade and cost both sides millions of dollars."*

[1459] See for a comparison, Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 546 and Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation', 15 *Virginia Tax Review* 89 (1995).

[1460] On the value of property, e.g., that of intangible assets, see Gordon V. Smith et al, *Valuation of Intellectual Property and Intangible Assets (2000)*, at 7: *"intellectual property values, as such, come from the rights to exclude others from using it."* See also Lawrence Lokken, 'The Sources of Income From International Use and Dispositions of Intellectual Property', 36 *Tax Law Review* 233 (1980-1981). Lokken argues at 240 and 253 that intellectual property rights derive their value from the owner's right to exclude others from using it. The right to use, Lokken submits, is the principal ingredient of the bundle of rights comprising ownership. At 277, Lokken establishes that intellectual property is valuable because competitors are refrained from using or exploiting the associations that constitute the property. Intellectual property yields income to its holder as competition is restrained. In a constitutional state, the opposite holds as well. Without the exclusivity right, the property would be worthless. Cf. Fred C. de Hosson, 'Multinational Enterprises and the Development, Ownership and Licensing of Trademarks and Trade Names', 11 *Intertax* 398, at 401: *"Without the recognition and (…) the protection of the trademark in a state's legal system, there is no ownership and thus no value."* Indeed, the very essence underlying value is ownership. Without ownership rights, property is worthless since non-exclusive. If available to all to utilize, why pay for it? If property is at one's free disposal, it would be commercially worthless. That would discourage investment and innovation, which explains why (intellectual) property ownership rights exist in the first place. The exclusivity privilege provides an incentive to produce socially desirable innovations. Without some guarantee of private ownership, investors would not put resources into inventive activities as their findings would rapidly be imitated, leaving them with no profit. The rights assist creators to appropriate returns of their innovation for themselves, i.e., the monopoly privilege.

[1461] See, for a comparison, Richard M. Bird, 'Shaping a New International Tax Order', 42 *Bulletin for International Fiscal Documentation* 292 (1988), at 296, and Gordon V. Smith et al, *Valuation of Intellectual Property and Intangible Assets (2000)*, at 399.

[1462] See for a comparison Steve Christensen, 'Formulary Apportionment: More Simple – On Balance Better', 28 *Law and Policy in International Business* 1133 (1996-1997), at 1156-1157: *" the "best fit" nature of the regulations invites tax planners first to calculate the transfer price using all four methods, then choose the method that has the best tax consequences, and finally build a case as to why the method represents the "best fit."*

The issue comes to light when intangibles are involved, as the exclusivity privilege now relates to high-worth intellectual achievements, intellectual property rights.[1463] Intangibles such as brands, patents, software and the like typically are the multinational's key rent drivers, its 'crown jewels', and, hence of great commercial value to the firm.[1464] Intangibles provide the multinational its advantage over its competitors and with that the potential to produce infra-marginal returns. Multinationals do not sell their crown jewels on the market; they keep them in-house. This explains the non-existence of third-party benchmarks in this area.[1465] That is, to base upon the arm's length nature of intra-firm transactions, such as intra-group intangible asset licensing arrangements, i.e., transactions that independent enterprises do not engage into.[1466] And this perhaps explains the presence of 'IP HoldCos' or 'shell companies' in low taxing jurisdictions.[1467]

In summary, multinationals thrive in the global marketplace by generating rents that are the outcome of market imperfections and the global provision of unique products and services. Multinationals are able to produce and market these novelty items globally as a functionally integrated monopolist. Their excess earnings are driven by their exclusivity privileges in commercially exploiting the property rights on intellectual achievements, intangibles, the multinationals' backbones. International taxation, however, encounters severe difficulties in geographically capturing these rents. No wonder. It adopts legal and physical-geographical connecting factors ('nexus'), and a functionally segregated (SA – the 'smoke') market value oriented (ALS – the 'mirrors') tax allocation methodology.

Is traditional SA/ALS appropriate in a global market dominated by multinationals? I tend to think not, there is a conceptual defect in its fundamental design.[1468] And interestingly, it is the mere presence of multinationals in the market that illustrates this.

[1463] See for a comparison Yariv Brauner, 'Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes', 28 *Virginia Tax Review* 81 (2008).

[1464] Note that it is not the intellectual achievement itself that constitutes the object of the discussion, it is the property rights associated with it (e.g., trademarks, (design) patents, copyrights, and know-how, trade secrets, recipes). Intellectual achievements may be legally protected, first, by means of statutory *in rem* entitlements, e.g., regulated by written statutes, such as trademark laws, patents laws, and copyrights laws). These provide exclusivity rights to the legal owner within a certain jurisdiction during a definite (e.g. patents) or indefinite (e.g., trademarks) time-period. Second, intellectual achievements may be protected by means of non-statutory *ad personam* entitlements, i.e., by keeping the data secret (e.g. know-how, trade secrets, or recipes). To keep data secret, walls of legal protection against infringements are built by means of tort (e.g., antitrust law) or contract (e.g., confidentiality agreements with business partners or employees). Cf. Gordon V. Smith et al, *Valuation of Intellectual Property and Intangible Assets (2000)* at 27-54. Contra, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at 2.137 and 9.80: '*not all valuable intangible assets are legally protected*'.

[1465] See for a comparison Roberto Moro Visconti, 'Exclusive Patents and Trademarks and Subsequent Uneasy Transaction Comparability: Some Transfer Pricing Implications', 40 *Intertax* 212 (2012, No. 3), at 212-219.

[1466] See for a comparison Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 712, who also refers to the difficulties of finding comparables, especially in cases where legal transactions between affiliated entities may not be replicated. Worth noting is the somewhat awkward language used in this respect in OECD, *Revised discussion draft on transfer pricing aspects of intangibles*, 30 July 2013, OECD, Paris, 2013, at 134: *"In conducting a* comparability analysis [emphasis added, MdW] *with regard to a transfer of intangibles, it is therefore* essential to consider the unique features [emphasis added, MdW] *of the intangibles."* I have some difficulties putting my mind around this. How is one to find a comparable relating an unique intangible? Moreover, interestingly, in setting forth a description of features of intangibles to be taken into consideration when performing the comparability analysis, the OECD does not forward any features of the characteristics of the underlying intellectual achievement. Rather, it focuses on legal terms relating to the intangible asset transfers or the modes involving its economic value. This may perhaps be explained by recognizing the uniqueness of the intellectual achievement. Inconveniently, here the OECD implicitly forwards the principal argument to establish the intrinsic failure of ALS, i.e., the required quest for the third-party equivalent. The gist is that it is not there. The intellectual achievement is unique.

[1467] See for a comparison, Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 5-17, who refer to the international tax practice of assigning income to special purpose subsidiaries in tax-haven countries. See on the utilization of shell companies for taxable profit shifting purposes also U.S. Department of the Treasury and Internal Revenue Service, *A Study of Intercompany Pricing under Section 482 of the Code*, Notice 88-123 (1988-2 C.B. 458), 18 October 1988, Washington D.C. ('White Paper'). Further, see Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 17, who refers to evidence that the enforcement of the arm's length standard is not sufficient to prevent profit shifting by manipulating transfer prices. For this purpose, Mayer cites Martin A. Sullivan, 'Data Show Big Shift in U.S. Income to Tax Havens', *Tax Notes International* 28 (2 December 2002), at 876-879.

[1468] Cf. Stanley I. Langbein, 'The Unitary Method and the Myth of Arm's Length', 30 *Tax Notes* 625 (17 February 1986), at 656 and 666, and Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J.

6.3.4.3 *Recognizing the continuum price problem in transfer pricing trends: towards 'residual profit splitting'*

6.3.4.3.1 *Evolution in transfer pricing methods reveals a shaking-off of traditional SA/ALS concept*

While recognizing the continuum price problem, the following should be submitted. An assessment of the transactional based and profits based transfer pricing methods used in practice today reveals an implicit recognition of the problem, and in response to that a conceptual shaking-off of traditional SA/ALS as well as a subsequent conceptual sloping towards a formulary approach. An analytical lining-up of the transfer pricing methods under OECD and US standards, reveals that these first move away from the concept of separate accounting to subsequently, second, cast aside the arm's length standard altogether. In its attempts to geographically localize and evaluate the residual, SA/ALS seems on its way to cancelling itself out.

Fig.82. 'Comparing OECD and US TP-approaches'

An analytical lining-up of the various OECD and US transfer pricing methods is attainable as all share common grounds.[1469] The US differentiates in practice between transfer pricing methods applicable in respect of (in)tangible transactions and service transactions. [1470] The OECD does not make such a categorization. The difference, however, is more of a practical than of a conceptual nature. Moreover, similarly, neither the OECD nor the US adopts a particular

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Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 272: *"[T]he transfer-pricing rules (…) are flawed conceptually"*. See also Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 18: *"All these practical problems seem to support theoretical objections (…) against the current transfer pricing regime. Probably the most relevant line of argument is that the current implementation of the arm's length standard is not consistent with the economic realities of integrated multinational enterprises. (…)Problems in taking into account of the increased profitability of integrated groups of companies represent another aspect. Economic theories on multinational enterprises imply that enterprises combine into groups and replace market supplies by intragroup transactions if and because this leads to increased profitability. This is the reason why the higher degree of integration of businesses makes the arm's length fiction appear more and more artificial. Traditional transfer pricing does not take account of the additional profitability of internationally integrated enterprises, and several authors have suggested alterations to the current methods that would add some formulaic elements to distribute residual profits that are earned beyond what would have been realized by independent entities."* See also Michael Mazerov, 'Why arm's length falls short', 5 *International Tax Review* 28 (1994), at 28-32: *"[T]he corporate income tax is critically ill and the arm's length medicine isn't working. Side- effects or no, a new formula is called for." "That (…) arm's length pricing adjustments are not a cure but only a very poorly functioning life support system is suggested by the alarm bells that go off on an almost daily basis."* And: *"The theoretical and practical shortcomings of the arm's length system have been described and illustrated much better than I can possibly do in the space available here. However, no one has described the inherent futility of the arms 's length approach more straightforwardly than the anonymous practitioners quoted in the cover story of International Tax Review, October 1993, which aired corporations' opinion of various global tax issues. As one corporate tax specialist said: "When you multiply a situation by hundreds of thousands of transactions, conducted in different economic situations, involving a range of different products, then the problems, the cracks in the theory, really start to show. (…) Another person stated the obvious: "It would be impossible to have an APA for each product line, and there is no one product line that can be singled out.""* Notably, the OECD, indeed quite ambivalently, refers to transfer pricing as not being an exact science, but simultaneously to ALS as being sound in theory. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 1.13 and 1.14. I have some difficulties appreciating this.

[1469] The OECD methods are laid down in the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at Ch. II. Most countries generally endorse the methods in the OECD Transfer Pricing Guidelines in their domestic transfer pricing laws. Exceptions, for instance, are Brazil and China, who adopt their own rules (which sometimes refer to fixed margins). See for some elaboration UN Practical Transfer Pricing Manual for Developing Countries, Ch. 10 (Country practices). In the US, the arm's length standard and the available transfer pricing methods are laid down in Section 482 IRC and the US Treasury Regulations under Section 482 IRC, 26 CFR 1.482.

[1470] See 26 CFR 1.482-1(a)(1). *Section 1 "sets forth general principles and guidelines to be followed under section 482. Section 1.482-2 provides rules for the determination of the true taxable income of controlled taxpayers in specific situations, including controlled transactions involving loans or advances or the use of tangible property. Sections 1.482-3 through 1.482-6 provide rules for the determination of the true taxable income of controlled taxpayers in cases involving the transfer of property. Section 1.482-7T sets forth the cost sharing provisions applicable to taxable years beginning on or after January 5, 2009. Section 1.482-8 provides examples illustrating the application of the best method rule (26 CFR 1.482-1(c)). Finally, § 1.482-9 provides rules for the determination of the true taxable income of controlled taxpayers in cases involving the performance of services."*

hierarchy in transfer pricing methods. The taxpayers involved are required to apply the 'most appropriate method' (OECD)[1471] or the 'best method' (US), though.[1472] Further, with respect to intra-firm intangible asset transactions, both the OECD and the US effectively recognize some kind of 'hindsight-approach', i.e., the possibility of *ex post* altering transfer prices dependent on the actual commercial performance of the intangible's exploitation in the market. The OECD sets forth that the arm's length standard may require associated enterprises to agree on so-called 'price adjustment clauses'.[1473] Section 482 of the US IRC contains the so-called 'commensurate with income standard', which allows the US tax authorities to adjust *ex ante* established arm's length transfer prices *ex post*, i.e., on a hindsight basis, if the returns yielded differ from the expected return at the time of the investment.[1474] In addition, both the OECD and US enable taxpayers to employ alternative non-specified transfer pricing approaches in cases where the specified methods produce non-meaningful results, for instance based on valuation techniques (e.g., income approach, replacement cost approach, market value approach). Finally, both the OECD and the US sees room for cost allocation, i.e., the charging for certain activities by reference to costs incurred with no markup, i.e., activities for which independent parties would not be willing to pay.[1475]

The 'SA/ALS-cancelling-itself-out effect' may be appreciated if one recognizes the trends in practice towards an increased application of the 'residual profit split' method in transfer pricing. On the basis of this method, the combined profit (or loss) of the associated enterprises involved is attributed geographically by reference to some firm specific key that is referred to as the 'relative contributions of functions performed'. The combination of profits encroaches upon the concept of separate accounting. As it considers the profit of the combination as a whole, it is implicitly oriented towards a unitary approach that recognizes the combination as a single entity. The practice of subsequently allocating the combined profit by reference to an evaluation of functions performed erodes the concept of arm's length pricing. It surpasses the need to perform a third-party comparability analysis and allocates profit directly by reference to the activities undertaken. It accordingly breaks away from the foundation underlying the arm's length standard, i.e., the comparison of the intra-firm transaction with a third-party equivalent.

As will be shown, however, ultimately even the residual profit split method proves unfeasible as a key to evaluate firm inputs at their origin. This paves the way to analytically introduce the formulary alternatives in this area. Please keep this in mind as we proceed.

6.3.4.3.2 Blowing away the smoke: towards 'combined profit'

[1471] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.2., and OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at par. 184.

[1472] See 26 CFR 1.482-1(c).

[1473] See further, OECD, *Revised discussion draft on transfer pricing aspects of intangibles*, 30 July 2013, OECD, Paris, 2013, at par. 201: *"… independent enterprises might not find that pricing based on anticipated benefits alone provides an adequate protection against the risks posed by the high uncertainty in valuing the intangible property. In such cases, independent enterprises might adopt shorter term agreements or include price adjustment clauses in the terms of the agreement, to protect against subsequent developments that might not be predictable."* See further at 205: *"If independent enterprises would have insisted on a price adjustment clause in comparable circumstances, the tax administration should be permitted to determine the pricing on the basis of such a clause."* On price adjustment clauses, see also *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Chapter VI at par. 6.30-6.35. See on price adjustment clauses also OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Guidance on Transfer Pricing Aspects of Intangibles*, Paris, 16 September 2014.

[1474] For some discussion on the 'commensurate with income' requirement, see Yariv Brauner, 'Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes', 28 *Virginia Tax Review* 81 (2008). See also William P. Elliot, 'Development, Ownership and Licensing of Intellectual and Intangible Properties – Including Trademarks, Trade Names and Franchises', *Taxation of Corporate Transactions* 21 (2004). Further, note section 367(d) and 26 CFR 1.367(d)-1T. In respect of US outward bound intra-group intangible property transfers, this section establishes that the non-US transferee/user of the intangible is deemed to pay the US transferor/developer a royalty that is commensurate with the income derived by the non-US associated entity from using the intangible. The section applies regardless whether, in fact, such a royalty is paid or not. This may even result in US withholding tax levied on deemed royalty payments for the use of intangible property in the US.

[1475] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 7.9-7.11, as well as 26 CFR 1.482-9(b) (services cost method), 26 CFR 1.482-9*(k)(3)(l)(3)(iv*) (shareholder activities), and 26 CFR duplicative activities .482-9*(k)(3)(l)(3)(iii*).

Comparable uncontrolled pricing, but there is no third-party comparable

The concept of SA/ALS is acknowledged to its fullest under the first set of OECD and US transfer pricing methods in the line-up. These are the transaction-based comparable uncontrolled price method (OECD/US),[1476] the comparable uncontrolled transaction method (US),[1477] and the 'comparable uncontrolled service price method' (US).[1478] These fully appreciate the segregation of associated enterprises charging arm's length prices for intra-firm transactions, as this method requires a comparison of the price charged for the controlled transaction to the price charged for the comparable uncontrolled transaction. The arm's length value of the intra-firm transaction is accordingly evaluated by reference to the market value of the comparable transaction undertaken by the respective associated enterprise in its dealings with actual third parties.

However, unfortunately, the comparable uncontrolled price method has foregone its purpose in the current global marketplace. As elaborated in the above, multinational firms typically derive their rents by innovatively exploiting monopoly privileges that are carefully being kept in-house. Open markets on which multinationals trade their intermediate intangibles with third-parties are seldom, if ever, to be found.[1479] Multinationals do not trade their rent producing crown jewels on the market. Comparable third-party transactions are absent.

The CUP-method is a relic from a mercantile past where international trade primarily evolved around bulk goods traded at readily available global commodity prices. [1480] That holds true regardless of the fact that the comparable uncontrolled price method is generally preferred, e.g., by the OECD over the other transfer pricing methods if different methods can be applied in an equivalently reliable manner.[1481] In the end, it is of no use to properly allocate the multinational residual.

Resale minus and cost-plus, but practical problems and conceptual issues (one-sided, comparables absent)

Where actual third-party transactions are absent, SA/ALS is still fully acknowledged under the second set of methods in the line-up. These are the transaction-based 'resale price method' (OECD/US),[1482] the 'gross services margin method' (US) on the one hand,[1483] and the 'cost-plus method' (OECD/US),[1484] and the 'cost of services plus method' (US)[1485] on the other. These methods also appreciate the segregation of associated enterprises charging arm's

[1476] On US CUP, see (1.482-3(b), tangible property) *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 22 July 2010, at par. 2.13-2.20.
[1477] On CUT, see 1.482-4(c).
[1478] On CUSPM, see 1.482-9(c)
[1479] See also Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 10.
[1480] SA/ALP was introduced in the 1920s, an era where related parties were relatively autonomous and only a relatively small amount of international trade of tangible goods occurred – typically the trading of bulk goods not embodying unique and complex technologies, with respect of which the prices of which were globally set on commodity trading markets. The readiness of available spot market prices of these commodities may explain the introduction of arm's length pricing regarding intra-group trade (with the particular focus on comparable uncontrolled prices, the primacy of CUP. See also Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 837 who refers to the primacy of applying the comparable uncontrolled price to an intra-group transaction is a relic from a mercantile age. See further Michael Mazerov, 'Why arm's length falls short', 5 *International Tax Review* 28 (1994), at 31, and J.T. van Egdom RA, *Verrekenprijzen; de verdeling van de winst van een multinational* (2011), at 76-77.
[1481] See e.g., *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.3: *"…where (…) the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred."*
[1482] On US Resale Price Method, see 1.482-3(c) –Gross margin of a distributor, tangible property). See also *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.21-2.38.
[1483] On GSMM, see 26 CFR 1.482-9(d).
[1484] On US Cost Plus Method, see (1.482-3(d) – Gross margin of a manufacturer, tangible property). See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.39-2.55.
[1485] On CSPM, see 26CFR 1.482-9(e).

length prices for intra-firm transactions, since all require a comparison of the price charged for the controlled transaction to the price charged for a third-party equivalent.[1486]

To arrive at the arm's length price (range), the OECD resale price method and its US equivalents require a comparison of the gross resale price margin earned on a resale of goods to a third-party following a controlled purchase to the gross resale price margin earned on a resale in a comparable third-party scenario (i.e., had the product been purchased from a third-party). It evaluates whether the charged amount in the controlled environment is arm's length by reference to the margin realized in a comparable uncontrolled environment.

As regards the cost plus method, the arm's length price (range) is determined by means of a comparison of the gross mark-up realized on the costs incurred from a third-party transaction preceding a controlled transaction to the gross mark-up on costs incurred in a comparable third-party scenario (i.e., had the product been provided to a third-party).[1487] It evaluates whether the charged amount in the controlled environment is arm's length by reference to the gross cost-plus mark-up earned in a comparable uncontrolled environment. Under both clusters of methods, the value of the intra-firm transaction is accordingly sought to be evaluated by reference to the market value of a third-party comparable.[1488]

However, unfortunately, these transaction-based methods have also foregone their purpose in the current global market place. That is for both practical and conceptual reasons. In practice, both the multinational and the tax authorities need to know the profit margins of unrelated party transactions.[1489] That triggers a problem as information on third-party gross-profit level indicators may neither be available nor reliable, e.g., in publicly available commercial data. Further, uncertainties and potential double (non-)taxation issues may arise as the commercial accounting standards used in practice (e.g., IAS/IFRS, US GAAP) sometimes differentiate in defining gross and net returns.[1490] And finally, practical issues may emerge as the transactional approach adopted here requires per-transaction pricing, particularly when the multinational involved undertakes substantial volumes of internal transactions.

Conceptual issues emerge first, since these transfer pricing methods are all one-sided methods. Only one of the parties involved in the intra-group transaction is assessed, i.e., the tested party. Under the resale price method the tested party is the controlled reseller. Under the cost-plus method it is the controlled supplier. Typically, the tested party is the associated enterprise performing the less complex part of the functions involving the controlled transaction (e.g., low-risk manufacturing, reselling, servicing; distribution / marketing).[1491] The

[1486] Please note that the transaction based transfer pricing methods are favored by the OECD over the profits based methods. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.3: *"… where a traditional transaction method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method. Moreover, where (…) the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred."* This makes sense as these methods quintessentially recognize SA/ALS, while the profits based methods conceptually move away from it. This may also explain the traditional hesitation of the OECD towards these latter mentioned methods. Today, the OECD has embraced them, since the traditional transactional methods have proved to be of an increasingly lesser use to allocate profits in today's global economy. The US traditionally has lesser problems with profits based methods. This, perhaps, may be explained by pointing at their experiences with formulary apportionment systems that are in place to divide interstate corporate profits to the US states. Formulary systems typically divide the combined profits by means of predetermined formulas – see section 4 hereunder.

[1487] Notably, J.T. van Egdom RA, *Verrekenprijzen; de verdeling van de winst van een multinational* (2011), at 82, argues that it would seem to make sense to establish the arm's length mark-up on budgeted costs. Otherwise, the scenario could occur that a cost-inefficient operation would be rewarded a relatively higher profit.

[1488] In practice these methods are commonly applied in respect of sales of(semi-finished) products, for instance under intra-firm long-term buy-and-supply arrangements, or the provision of services, for instance under intra-firm (joint) facility agreements. Notably, Andrew Casley, 'The Basic Framework of the Cost-Plus Method', 6 *International Transfer Pricing Journal* 38 (1999), at. 38-44, sets forth that cost-plus mark ups typically range between 5 and 15%.

[1489] See Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 10.

[1490] See M. Cools, 'International Commercial Databases for Transfer Pricing Studies', 6 *International Transfer Pricing Journal* 5 (1999), at 178-182. See also Hubert M.A.L. Hamaekers, 'Arm's Length - How Long?', 8 *International Transfer Pricing Journal* 30 (2001), at 35.

[1491] See e.g., OECD, *Revised discussion draft on transfer pricing aspects of intangibles*, 30 July 2013, OECD, Paris, 2013, at par. 209: *"In a transfer pricing analysis where the most appropriate transfer pricing method is the resale*

remainder of the transactional profit is allocated to the non-tested associated party in the transaction.

The consequence of adopting such one-sided methods is that they tend to underestimate the transfer price as it assigns all unallocated profit to the non-tested party, i.e., the seller under the resale price method and the buyer under the cost-plus method.[1492] This provides multinationals some discretion in geographically attributing the residual. Moreover, under the cost-plus method, the value of the internal transaction is measured by reference to costs incurred, i.e., the idea of the costs of replacement as value indicator. This may be regarded as conceptually unsound as costs do not correlate to value, particularly when intangibles are involved.[1493]

Second, and more substantially, these methods in the end are also conceptually incapable of properly allocating multinational rents. That is, for the same reasons as submitted in the above. As said, multinational firms derive their rents by innovatively exploiting the monopoly privileges they keep in-house. As outside markets are absent here, the requirement to search for comparables, and with that the use of these transfer pricing methods, is senseless since comparable third-party transactions do not exist.

Breaking with 'transactional approach': TNMM and comparable profits method, but still conceptually problematic (one-sided, comparables absent)

To counter some of the practical difficulties of charging an arm's length price per individual intra-firm transaction, the third set of transfer pricing methods in the line-up starts sloping away from traditional SA/ALS by throwing overboard the traditional transactional approach. These methods are (effectively) the 'transactional net margin method' (OECD),[1494] and the 'comparable profits method' (US)[1495] and 'comparable profits method for services' (US).[1496] These are attached to the segregation of associated enterprises and the reliance on third-party comparables. But contrary to the traditional transaction transfer pricing methods, they move away from the concept of pricing individual intra-firm transactions.

Viz., the transactional net margin method (OECD), for instance, allows accounting for firm level aggregates of controlled transactions. To arrive at the arm's length price (range), the transactional net margin method requires a comparison of the net profit margin (EBIT) relative to an appropriate base (turnover at origin, costs or assets) earned on a particular controlled transaction or an aggregation of controlled transactions with the operating income earned in a comparable third-party scenario. If the margin is determined relative to turnover, the method operates as a net variant of the resale price method. If it is determined relative to costs, it is a net variant of the cost-plus method.[1497]

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price method, the cost-plus method or the transactional net margin method, the less complex of the parties to the controlled transaction is often selected as the tested party. (…) That would generally be the case where only the non-tested party uses intangibles". See also *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.26 and 3.18, and OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Guidance on Transfer Pricing Aspects of Intangibles*, Paris, 16 September 2014.

[1492] See Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 10.

[1493] See for a comparison James R. Hines Jr., 'Income misattribution under formula apportionment', 54 *European Economic Review* 108 (2010, No. 1), at 108-120, as well as OECD, *Revised discussion draft on transfer pricing aspects of intangibles*, 30 July 2013, OECD, Paris, 2013, at par. 161: *"in some limited circumstances, transfer pricing methods based on the estimated cost of reproducing or replacing the intangible may be utilised."* See also *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Chapter VI at par. 6.27: *"there is no necessary link between costs and value."* And see OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Guidance on Transfer Pricing Aspects of Intangibles*, Paris, 16 September 2014.

[1494] On TNMM, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.58-2.107.

[1495] On CPM, see 1.482-5 (tangible property).

[1496] See 26 CFR 1.482-9(f).

[1497] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.58. Notably, for some illustrations of TNMM and sensitivity effects of utilizing gross and net profit level indicators, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Annex I to Chapter II.

The comparable profits method (US) conceptually foregoes the transactional approach altogether. To arrive at the arm's length profit attribution, it requires a comparison of the operational profit (EBIT) in the controlled environment to the operating profit in a comparable third-party scenario. It accordingly compares overall results rather than individual transactions, i.e., an income comparison.[1498] Notably, the comparable profits method operates identically to the transactional net margin method where the latter computes matters by reference to firm level aggregates of controlled transactions.[1499] As both methods allow for a conceptual bypassing of the transactional approach, the value that the tested party adds to the multinational firm is sought to be evaluated by assessing the profitability of third-parties performing equivalent business operations.[1500] The transactional approach, accordingly, proves to not be a necessity in transfer pricing.

However, unfortunately, these transfer pricing methods have also foregone their purpose in the current global market place. That is particularly for conceptual reasons, as they may resolve some of the pragmatic concerns. As these methods allow for income comparisons, there is no need to transfer the price of individual transactions. Accordingly, there is no need to disentangle the often sizeable aggregates of intra-firm transactions, i.e., scenarios where it may be practically unfeasible to analytically segregate them.[1501] Further, as operational profits are assessed, net-profit level indicators may be used. These typically are more easily extractable from the public financial data of companies. It also mitigates the aforementioned issues of accounting standards differentials in defining gross and net returns. These administrative eases may explain the popularity of these methods in practice.[1502]

Conceptual issues emerge for similar reasons as those set forth in the above. First, these transfer pricing methods are also one-sided methods. Just one of the parties involved in the intra-group transaction is assessed, i.e., the tested party – typically, the associated enterprise performing the less complex functions.[1503] The non-tested associated party is awarded the

[1498] Cf. Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 830, and Hubert M.A.L. Hamaekers, 'Arm's Length - How Long?', 8 *International Transfer Pricing Journal* 30 (2001), at 35.

[1499] Cf. Toshio Miyatake, 'General Report – Transfer Pricing and intangibles', in International Fiscal Association, *Cahiers de droit fiscal international* (2007) 17, at 32. See also Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 13.

[1500] See Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 11. In practice these methods are commonly applied to associated enterprises performing low risk routine functions, such as toll and contract manufacturing, contract R&D and contract marketing, and limited risk distribution functions. See for a discussion of one of the variants of the method as applied in practice, C.J. Eduard A. Sporken et al, 'Possible Application of the Berry Ratio for the Distribution Function in the Consumer Electronics Industry in Europe', 17 *International Transfer Pricing Journal* 257 (2010). The authors contend that the Berry ratio, i.e., the ratio of gross profit to operating expenses (i.e., cost plus on operating expenses), could be seen as being included in the OECD Guidelines. They consider the Berry ratio to establish a relative net margin, constituting an appropriate profit level indicator under the TNMM method, e.g., to be employed for intra-group distributors in the consumer electronics industry. The authors contend that the Berry ratio is not dismissed under the OECD Transfer Pricing Guidelines as the Guidelines do not precisely define what is exactly meant by a net margin within the TNMM. Notably, the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, refer to the use of Berry ratios under TNMM in par. 2.100-2.102.

[1501] See e.g., 26 CFR 1.482-1(f)(2)(i) (Aggregation of transactions), and 26 CFR 1.482-4(c)(2)(iii)(B)(1) on embedded intangibles. See also *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 3.9-3.12 on the pricing of aggregates of transactions and package deals. On package deals see further, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 6.17: *"The transfer price may be a package price, i.e. for the goods and for the intangible property, in which case, depending on the facts and circumstances, an additional payment for royalties may not need to be paid by the purchaser for being supplied with technical expertise. This type of package pricing may need to be disaggregated to calculate a separate arm's length royalty in countries that impose royalty withholding taxes."* For some discussion on aggregated transactions and mixed contracts see, Toshio Miyatake, 'General Report – Transfer Pricing and intangibles', in International Fiscal Association, *Cahiers de droit fiscal international* (2007) 17, at 17-38.

[1502] See Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 11.

[1503] See e.g., OECD, *Revised discussion draft on transfer pricing aspects of intangibles*, 30 July 2013, OECD, Paris, 2013, at par. 209: *"In a transfer pricing analysis where the most appropriate transfer pricing method is the resale price method, the cost-plus method, or the transactional net margin method, the less complex of the parties to the controlled transaction is often selected as the tested party. In many cases, an arm's length price or level of profit for the tested party can be determined without the need to value the intangibles used in connection with the transaction.*

residual. This again has the consequence of underestimating the profit allocated to the tested party, which provides multinationals some discretion in attributing their rents geographically.

Second, and more substantially, these methods in the end are also conceptually incapable of properly allocating multinational rents. That is, again, for similar reasons as set forth above. Integrated multinationals may derive profits that exceed the joint profits of non-integrated companies performing similar functions.[1504] Further, as multinationals derive their rents through the utilization as a monopolist of innovative advantages, the required search for comparable profit levels is senseless as third-party comparables do not exist.

Breaking with 'separate accounting'; comparable profit split, but still a conceptual issue: comparables still absent

To resolve the conceptual issues that arise under the one-sided methods, the fourth transfer pricing method in the line-up gets rid of the 'smoke'. It not only bypasses the transactional approach, but also moves away from the concept of separate accounting, i.e., the 'SA' in 'SA/ALS'. The method referred to is the American profits-based 'comparable profit split method'.[1505] It conceptually slopes away from SA, since it relies on the allocating of the 'combined profit', i.e., the pooled profit of the combination of associated enterprises involved by reference to third-party comparables.[1506] The profits are subsequently divided by reference to a third-party comparison. Taking the combined profits as a starting point, apparently, SA proves not to be a necessity in transfer pricing.[1507]

Viz., to arrive at the arm's length profit attribution, the comparable profit split method requires a comparison of the combined operating profit of the associated enterprises conducting the business activity involved to the combined operating profit of uncontrolled taxpayers whose transactions and activities are functionally similar to those of the tested affiliated taxpayers. Each uncontrolled taxpayer's percentage of the combined operating profit or loss is used as a reference to allocate the combined operating profit or loss of the relevant business activity in the controlled environment. The value that the tested associated entities add to the multinational is accordingly sought to be evaluated by assessing the profitability of third-parties performing equivalent business operations.

But unfortunately, the comparable profit split method is also of little use in today's global market, particularly for conceptual reasons. Although the method may be considered a two-sided transfer pricing method – contrary to the one-sided methods referred to in the above –

That would generally be the case where only the non-tested party uses intangibles." See also *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.58: *"A transactional net margin method is unlikely to be reliable if each party to a transaction makes valuable, unique contributions (…). In such a case, a transactional profit split method will generally be the most appropriate method (…). However, a one-sided method (traditional transaction method or transactional net margin method) may be applicable in cases where one of the parties makes all the unique contributions involved in the controlled transaction, while the other party does not make any unique contribution. In such a case, the tested party should be the less complex one."* See further *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.26 and 3.18. See also OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Guidance on Transfer Pricing Aspects of Intangibles*, Paris, 16 September 2014.

[1504] See Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 11.

[1505] On comparable profit split, see 26 CFR 1.482-6(c)(2).

[1506] The concept of 'combined profit' is conceptually similar to the pooling of corporate profits, e.g., under a UK-style profit-pooling mechanism or a German-style 'Organschaft' system. However, here the cross-border profits are being pooled. The income earned by a group of related companies engaged in a common enterprise is determined by adding together, i.e., 'combining', the stand-alone profits of the various tax-segregated entities. Accordingly, this approach appreciates that the income earned by such a group is, in substance, the income of the enterprise itself, rather than the income of its constituent corporate parts. The concepts of combined profit and 'combined reporting' is also adopted is US formulary apportionment. For some elaboration on 'combined reporting' in the US, see Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 255. One analytical step further is cross-border tax consolidation, i.e., as discussed in Chapter 4 of this study.

[1507] This holds regardless of whether the intra-firm transactions re-emerge subsequent to the splitting process to fill in the arm's length transfer prices, i.e., the ensuing reverse process of calculating the allocated profit back to the (individual) intra-firm transactions undertaken by the (functionally) separate entities. Effectively, then, the allocation has already been done. Such a subsequent filling-in of numbers re-introducing separate accounting and arm's length pricing, then merely fulfills administrative purposes.

this does not entail that the method provides for an objective tool to objectively attribute the residual. As said, multinationals derive profits in excess of the joint profits of non-integrated companies performing similar functions. The consequence is that this transfer pricing method is incapable of accounting for these profits. Further, it fails to account for the infra-marginal returns generated through the commercial exploitation of the firm's unique intangibles. Again, the required third-party comparison is senseless. That is regardless of the fact that the smoke has now been blown away.

6.3.4.3.3 Breaking the mirrors: approximating 'relative contributions of functions performed'

To resolve the issues that arise by requiring third-party comparables in an environment where these do not exist, the fifth set of transfer pricing methods in the line-up casts aside the 'mirrors'. These methods not only bypass the transactional approach and the separate entity approach, they also conceptually and essentially do away with the arm's length standard, i.e., the ALS in SA/ALS. The methods referred to are the profits-based '(residual) profit split method' (OECD/US),[1508] and the 'profit split method for services' (US).[1509] They conceptually slope away from SA, as they also rely on the allocation of 'combined profit'. Moreover, they move away from ALS as they seek to divide the combined profit by means of a firm-internal allocation key referred to as the 'relative contributions of functions performed'. That is, rather than through a third-party comparability analysis.[1510] It accordingly seems that ALS also proves not to be a necessity in transfer pricing.

Namely, to geographically assign the multinational's overall corporate profit – particularly the indistinguishable residual –[1511] the profit split method first identifies the combined profit of the associated business enterprises conducting the respective integrated business operation.[1512] Subsequently, second, it splits combined profit as derived by the combination. That is, in proportion to the relative economic contributions of its integrated parts in the respective countries involved. No third-party comparability analysis is performed for this purpose.[1513] The

[1508] On Profit Split, see 26 CFR 1.482-6, tangible property. On Residual profit split, see 26 CFR 1.482-6(c)(3). On Transactional (residual) profit split method, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.108-2.149.

[1509] See 26 CFR 1.482-9(g).

[1510] See for a comparison Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', *2 World Tax Journal* 3 (2010), at 3-18. Notably, the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.133 make reference to profit splitting by reference to third-party comparables. Here the OECD's profit split method conceptually operates as a US-style 'comparable profit split method'.

[1511] See e.g., *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.109: *"The main strength of the transactional profit split method is that it can offer a solution for highly integrated operations for which a one-sided method would not be appropriate. (…) A transactional profit split method may also be found to be the most appropriate method in cases where both parties to a transaction make unique and valuable contributions (e.g. contribute unique intangibles) to the transaction, because in such a case independent parties might wish to share the profits of the transaction in proportion to their respective contributions and a two-sided method might be more appropriate in these circumstances than a one-sided method. In addition, in the presence of unique and valuable contributions, reliable comparables information might be insufficient to apply another method. On the other hand, a transactional profit split method would ordinarily not be used in cases where one party to the transaction performs only simple functions and does not make any significant unique contribution (e.g. contract manufacturing or contract service activities in relevant circumstances), as in such cases a transactional profit split method typically would not be appropriate in view of the functional analysis of that party."* See also OECD, *Revised discussion draft on transfer pricing aspects of intangibles*, 30 July 2013, OECD, Paris, 2013, at par. 220: *"In some circumstances where reliable uncontrolled transactions cannot be identified, transactional profit split methods may be utilised to determine an arm's length allocation of profits for the sale of goods or the provision of services involving the use of intangibles. One circumstance in which the use of transactional profit split methods may be appropriate is where both parties to the transaction make unique and valuable contributions to the transaction,"* and *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 6.26: *"In cases involving highly valuable intangible property (…), the profit split method may be relevant (…)."* See also OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Guidance on Transfer Pricing Aspects of Intangibles*, Paris, 16 September 2014.

[1512] See for some analysis Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 11.

[1513] See for some analysis Michelle Markham, 'Tax in a Changing World: The Transfer Pricing of Intangible Assets', 40 *Tax Notes International* 895 (5 December 2005), at 895-906.

economic contributions – the values added at origin – are determined on the basis of a 'contribution analysis'. This essentially is a functional and factual assessment of the functions performed. The contributions of these functions ('nexus') are subsequently evaluated and weighted ('allocation'). The evaluation and weighting of the functions performed generally occurs indirectly, i.e., on the basis of proxies referring to firm-internal allocation factors.[1514] These factors typically are asset values, capital invested, costs incurred, wages, headcounts, ftes, time spent, turnover (at origin), et cetera.[1515] Notably, the residual profit split method operates correspondingly with the exception that it first seeks to allocate the returns from routine-contributions using third-party comparables. It then apportions or allocates the residual using the profit split method – assuming that this profit is attributable to the non-routine firm rents.[1516] Notably, parallel to the upcoming of intangibles and e-commerce, the profit split method is utilized to an increasingly greater extent in tax practice.[1517]

Interestingly, in its attempts to assign multinational rents, transfer pricing practice ends up using firm-internal, endogenous profit producing factors like assets, payroll and sales to approximate the relative values of the functions performed.[1518] The profit split method is argued, e.g., by the OECD to produce at arm's length results as it is said to intend to approximate the division of profits that would have been anticipated and reflected in a third-party environment.[1519] However, this raises the question of how to substantiate that. *"Once you do not base the ALS on finding comparables, then it is not very meaningful to say that a particular method is or is not compatible with the ALS, because if there are no comparables you cannot prove that the result reached by that method was not what unrelated parties would have done at arm's length."*[1520] Some submit that the profit split method is a pragmatic solution since it does not require third-party comparables.[1521] It may also be recognized as

[1514] See e.g., *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.141.
[1515] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.134-5.
[1516] Under the residual profit split method, the contributions producing the residual are determined on the basis of a 'residual analysis'. This essentially is a 'contribution analysis' performed to split the residual profit. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.121. For some illustration, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Annexes II and III to Chapter II.
[1517] See for instance Hubert M.A.L. Hamaekers, 'Arm's Length - How Long?', 8 *International Transfer Pricing Journal* 30 (2001), at 38, who refers to the emergence of this transfer pricing method. Already in 2001, Hameaekers argued that an increased application of profit split may reduce problems in the transfer pricing area. He concludes that the method deserves a more prominent position in international taxation. See also Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 826 who refers to the steady drift toward the use of some formulary allocation. Further see Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 546. For a comparison, see Reuven S. Avi-Yonah et al, 'Formulary Apportionment – Myths and Prospects; Promoting Better International tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative', 3 *World Tax Journal* 371 (2011), at 382, referring to the increased reliance of tax authorities on profit split methods. See further David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 2: Solutions to Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 235 (2004), at 240, and Michelle Markham, 'Tax in a Changing World: The Transfer Pricing of Intangible Assets', 40 *Tax Notes International* 895 (5 December 2005), who argues at 901 that *"as a result of the unique nature of intangible property, other less traditional transfer pricing methods* [i.e., profit split methods, MDW] *have become more relevant in ascertaining the arm's length nature of transactions involving those assets"*. See finally Toshio Miyatake, 'General Report – Transfer Pricing and intangibles', in International Fiscal Association, *Cahiers de droit fiscal international* (2007) 17, who sets forth at 33 that: *"the PSM, especially the RPSM, appears to be used more often than the CUP because appropriate comparables cannot be found for unique and highly valuable intangibles."*
[1518] The profit split method accordingly introduces formulary elements in transfer pricing. See Michelle Markham, 'Tax in a Changing World: The Transfer Pricing of Intangible Assets', 40 *Tax Notes International* 895 (5 December 2005), at 901.
[1519] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.108, and 2.116.
[1520] See Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', *2 World Tax Journal* 3 (2010), at 4-5.
[1521] See for a comparison, Toshio Miyatake, 'General Report – Transfer Pricing and intangibles', in International Fiscal Association, *Cahiers de droit fiscal international* (2007) 17, at 33: *"(…) the PSM* [profit split method; MdW]*, especially the RPSM* [residual profit split method; MdW]*, appears to be used more often than the CUP* [comparable uncontrolled price, MdW] *because appropriate comparables cannot be found for unique and highly valuable intangibles. The RPSM may be the most flexible and pragmatic method and it may have a merit in the three situations of (a) providing a pragmatic allocation of income between different classes of contributed intangibles without having to resort to third party transactions of dubious comparability; (b) dealing with situations involving a*

implied critique; transfer pricing practice embracing a method not in line with SA/ALS as it does not necessarily involve comparables.[1522]

In my view, it may be considered fair to observe that embracing the profit split method has essentially resulted in watering down SA/ALS in the process. SA/ALS has been surpassed and regarded as being unable to capture the residual by vainly seeking a comparable. That is, by arriving at some unitary taxation and formulary allocation approach approximating firm inputs at origin by reference to internal data. Indeed, essentially, the profit split method may be considered a quasi-formulary approach.[1523] In addition, it may accordingly be acknowledged that the practice of resorting to formulas in transfer pricing to assign a geographical source to corporate profit implicitly recognizes that income *"does not have an ascertainable "true" source."*[1524] Along with the smoke, the mirrors have been taken away as well. It seems that this is simply what the global market needs.[1525]

6.3.4.4 But how to objectively evaluate the fair value of firm inputs at origin?

Upside: profit split recognizes that firm constitutes a single entity

The conceptual upside of the profit split method is that it does away with the economically faulty SA/ALS approach in transfer pricing. By combining the associated enterprises' profits, it recognizes that the firm constitutes a single economic entity. Further, by casting aside the third-party comparability analysis, it recognizes that intra-firm transactions are being undertaken for business reasons. Under the profit split method, firm rents are included in the profit division process. Perhaps its increased use in tax practice may be seen as a *de facto* recognition of the unsuitability of SA/ALS.

This begs the question as to why not go all the way?[1526] Why not combine the multinational's worldwide profit and split it across countries on the basis of the (residual) profit split method, i.e., some form of global profit splitting by reference to tailored firm-internal apportionment formulae? Indeed, why bother entering into the fictitious world of SA/ALS just to realize that it does not work properly, and in turn leave it again? That is, why arrive at a profit allocation methodology that recognizes the unitary business characteristics of a multinational and proceed to allocate its worldwide rents by means of internal commercial data? Tax scholars have already suggested leapfrogging the whole thing, advocating the use of global profit splits or regional variants thereof.[1527]

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highly integrated global business; and (c) dividing the profits from business operations where contributions to intangible values are made serially by two or more related parties."

[1522] See for some analysis of this argument, Michelle Markham, 'Tax in a Changing World: The Transfer Pricing of Intangible Assets', 40 *Tax Notes International* 895 (5 December 2005), at 901.

[1523] Reuven S. Avi-Yonah et al, 'Formulary Apportionment – Myths and Prospects; Promoting Better International tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative', 3 *World Tax Journal* 371 (2011), at 383.

[1524] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 264.

[1525] See for a comparison Charles E. McLure, Jr., 'The State Corporate Income Tax: Lambs in Wolves' Clothing', in Henry J. Aaron et al (eds.), *The Economics of Taxation* (1980) 327, at 343.

[1526] That is, in the style of Michael Mazerov, 'Why arm's length falls short', 5 *International Tax Review* 28 (1994), at 28-32: *"In actual transfer pricing practice, national tax authorities have already moved far down the continuum from arm's length towards formula based profit splitting. Why not go all the way?"*

[1527] See for a comparison e.g., Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 510 who suggests some sort of global profit split by reference to functions performed. See further Antonio Russo, 'Formulary Apportionment for Europe: An Analysis and A Proposal', 33 *Intertax* 1 (2005), at 1-31, who proposes a pan-European residual profit split as an alternative to the Commission proposals for European Union wide formulary apportionment under its CCCTB Project. See also David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 1: The Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 55 (2004), as well as David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 2: Solutions to Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 235 (2004). Francescucci arrives at using multilateral RPSM to capture the multinational efficiency premium. He does not seem to go as far to propose global profit splits, though. Finally, see for a comparison OECD, *Revised discussion draft on transfer pricing aspects of intangibles*, 30 July 2013, OECD, Paris, 2013 in which the OECD seemed to move towards establishing an analysis from the perspective of the multinational's worldwide business operation, i.e., at least within the context of allocation profits from intangible asset commercialization. At par. 151: *"The selection of the most appropriate transfer*

Such a utilization of the (residual) profit split method to divide multinational worldwide combined profits attracts some difficulties, however. Yet, many of these may be resolved. First, it has been argued that the application of the profit split method may encounter difficulties in practice as the parties involved, i.e., both the associated enterprises and the tax administrations, may have difficulty accessing information from foreign affiliates.[1528] As a response, it should be noted that multinationals should have the required data readily available. The growing risk management demands in financial reporting and corporate governance require multinationals to be 'in control' of their business processes, including their tax positions.[1529] Further, data availability issues for tax administrations may be resolved by means of automatic information exchange mechanisms and / or country-by country reporting. Accordingly, the issue of data availability is an analytically separate matter. Second, it has been argued that problems may arise in computing multinational combined revenues and costs.[1530] That is, since the associated enterprises' commercial and tax accounting books differentiate due to the diverging approaches taken in this respect by the various countries involved. Also, this is an analytically separate issue, namely the mismatches in tax base computations, i.e., a disparity in taxable profit base definitions to be precise. This may be resolved by approximating tax base definitions. Tax base design has been discussed in Chapter 5 of this study. Further, worth noting is that worldwide combined reporting is utilized today regardless; for instance, under the California state income tax system (i.e., on an elective basis), and the global tax consolidation approaches in the French and Italian corporate tax systems which have been mentioned in Chapter 4 of this study.[1531] A third issue recognized is that the use of the profit split method requires a geographical assignment of costs incurred.[1532] This also is an analytically separate matter. Viz., it is an issue of nexus rather than allocation. Regardless of the merits of the argument in itself, the geographical localization of costs incurred is a matter dealt with in the first step of the profit attribution process ('nexus') under the functional and factual analysis.

Downside: subjectivities may leak in as future events need to be forecasted

One pivotal issue revolving around the use of the profit split method holds up. One problem truly seems unsolvable. How could the fair value of firm inputs at origin be segregated and evaluated? Profit splitting requires an analysis of how each function performed within the

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pricing method should be based on a functional analysis that provides a clear understanding of the MNE's global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business." Notably, Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, argues at 264 that *"[t]he OECD has been promoting, with the support of the financial services industry, the use of a formula for assigning financial services income derived from global trading of financial instruments to particular taxing jurisdictions."*

[1528] See e.g., *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.114.

[1529] Under corporate governance and risk management standards, today, MNEs are required to substantiate their positions in business or internal control frameworks. These are drafted for the purpose of issuing 'in control statements' to the multinational's stakeholders on various subjects, including corporate taxation. Indeed, as Christensen puts it, *"in a world of just-in-time inventory and activity-based cost accounting, it seems unreasonable to assume that the international manager does not have ready access to volumes of needed information."* See Steve Christensen, 'Formulary Apportionment: More Simple – On Balance Better', 28 *Law and Policy in International Business* 1133 (1996-1997), at 1156. Christensen proceeds to argue that *"[t]his internal information is exactly what an international tax auditor would be looking for in a formulary apportionment world."*

[1530] See e.g., *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.114: *"it may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies."*

[1531] See for some remarks Michael Mazerov, 'Why arm's length falls short', 5 *International Tax Review* 28 (1994), at 28-32, submitting that *"[s]ix tax years have come and gone since California, under intense political and economic pressure, abandoned mandatory worldwide unitary reporting and permitted all corporate taxpayers to make a water's edge election."* On the concept of worldwide unitary combination, see Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984).

[1532] See e.g., *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.114: *"when the transactional profit split method is applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises' other activities."*

multinational contributes relative to its overall profit making.[1533] But what is the value of the functions performed? Unfortunately, neither the OECD Transfer Pricing Guidelines nor, e.g., the US transfer pricing regulations under Section 482 IRC provide much guidance in establishing how the relative contributions of the functions performed and assets used could be evaluated.[1534] The OECD sets forth that *"[v]aluation techniques can be useful tools."*[1535] Let us therefore assess these techniques.

Essentially, value may be described as today's worth of expected future economic benefits.[1536] In practice, there are three generally accepted valuation methodologies: cost, market and income techniques. The first evaluates by reference to the cost of replacement, the second technique refers to market comparables and the third valuation method seeks to measure value by reference to the present worth of anticipated net economic benefits to be received in the future. When it concerns the evaluation of firm inputs at origin for tax allocation purposes, by deduction only the third technique merits some consideration.[1537] This is because cost ultimately does not explain rent, and market comparables are absent since rent production involves the commercialization of specialty items. Only the income-based valuation techniques truly focus on the income producing capabilities of multinational production factors.

The issue emerges. The splitting of profits by utilizing income-based valuation techniques requires some knowledge on the value of firm inputs and with that, future economic benefits. In practice, appraisers make use of discounted cash flow analyses or sophisticated Black-

[1533] For a comparison see Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 206 (footnote 1294): *"Using a specific formula for each group that individually reflects the relative contribution of each factor to profits, as proposed by Weiner, Formulary Apportionment and Group Taxation in the European Union (2005), p. 19, does not seem practicable, as this would necessitate for each group of companies regular complex analyses of how income is generated. Therefore, only the application of predetermined formulae is discussed (…)."* Mayer argues against the use of tailored apportionment formulae, which interestingly is a profit division approach substantially identical to utilizing the profit split method. Consequently, Mayer's argument would equivalently need to hold when assessing the profit method.

[1534] The *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.116 merely set forth that *"the combined profits are to be split between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length."* See Hubert M.A.L. Hamaekers, 'Arm's Length - How Long?', 8 *International Transfer Pricing Journal* 30 (2001), at 37, who also refers to the absence of OECD guidance on the relative weights to be put on the various functions performed. For a comparison, see Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 564, mentioning in respect of intangibles that the US Regulations refer to the location where the costs of developing the intangible asset that are presumed to give rise to the residual were incurred. Unfortunately, though, the location of cost does not say much about the location of profit. Cost, profit and value (the expected future profit) do not correlate. This renders the location of cost to geographically allocate profit somewhat meaningless. See for a comparison, OECD, *Discussion Draft; Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*, 6 June to 14 September 2012, OECD, Paris, 2012, at par. 112: *"There is little reason to believe that there is any correlation between the cost of developing intangibles and their value or transfer price once developed "*, and at par. 135: *"Valuation of intangibles on the basis of mark-ups over development costs is unlikely to provide an accurate measure of value and is generally discouraged.(…) Moreover, application of a resale price method analysis will be unlikely to constitute the most appropriate method for determining an arm's length price for intangibles or rights in intangibles in most situations."* See for a comparison James R. Hines Jr., 'Income misattribution under formula apportionment', 54 *European Economic Review* 108 (2010, No. 1), at 108-120.

[1535] See OECD, *Revised discussion draft on transfer pricing aspects of intangibles*, 30 July 2013, OECD, Paris, 2013, at par. 163. See for a comparison *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at Chapter VI. See also OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Guidance on Transfer Pricing Aspects of Intangibles*, Paris, 16 September 2014. For some illustrations on the guidance on intangible asset valuation, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, *Annex to Chapter VI*: *"Examples to Illustrate the Guidance on intangible Property and Highly Uncertain Valuation"*. For some analysis on this matter, see Andreas Oestreicher, 'Valuation Issues in Transfer Pricing of Intangibles: Comments on the Scoping of an OECD Project', 39 *Intertax* 126 (2011, No. 3), at 126-131.

[1536] See for thorough analyses on valuation, particularly in the area of intangibles Gordon V. Smith et al, *Valuation of Intellectual Property and Intangible Assets (2000)*, 638 pages. At 157, 163, 215 and 257, Smith and Parr define value as the present worth of future economic benefits. See further United Nations Economic Commission for Europe, Series: Investment Promotion, *Intellectual Assets: Valuation and Capitalization*, United Nations Publications, Geneva/New York, 2003, at 1-173.

[1537] Cf. Gordon V. Smith et al, *Valuation of Intellectual Property and Intangible Assets (2000)*, at Chapters 6 and 13, e.g., at 391: *"… the future economic benefits of ownership are key to transfer pricing issues"*.

and-Scholes real option-based valuation techniques for this purpose.[1538] These approaches are also utilized by tax practitioners.[1539] Yet, both valuation approaches require speculating the future. It is particularly difficult to objectively assess future volatile cash flows from the firm's rent yielding production factors, such as its intangible assets. The future is pretty hard to predict. Perhaps, accordingly, it may ultimately be impossible to truly objectively forecast future income, having the inevitable consequence of subjectivities leaking into the equation. Further, corporate value may differentiate depending on the eye of the beholder.[1540] Shareholders, the insurers, banks, the accountant and the taxman may not share views on the fair value of firm inputs.[1541]

6.3.4.5 Perhaps tax allocation should not rely on subjective beliefs on future earnings

So, the matter indeed seems to boil down to the premise that, at least up until now, it seems unfeasible to objectively allocate income on an origin basis. No objective formula proves available for this purpose. Fortunately, I am not alone in submitting this.[1542] Perhaps, in the

[1538] Income based methods such as discounted cash flow ('DCF') and real option ('RO') based valuation approaches estimate the net worth of future income streams with a view to the time value of money and potential future decision making. They seek to estimate the duration of the income streams by reference, e.g., of the expected economic useful life of the (intangible) assets used in the business process and the economic risks that are associated with the generation of the estimated income. To translate future income into present value, the future income stream is multiplied with a discount rate. Comparing DCF to RO methods, the latter is seen as an improvement to DCF evaluations. An issue with DCF is that it does not account for the flexibility of management to change course and defer, adapt, revise or abandon its decisions at later times in response to unforeseen developments in the market. As DCF basically refers to a 'one-time-all-or-nothing-decision-making-approach' which fails to include any value for information becoming available in the future, it may accordingly undervalue or overvalue an investment project. Econometric options based valuation techniques seek to take unforeseen future events into account by introducing a chance factor into the model. Such a factor 'change' seeks to account for the volatility of e.g., the firm's intangible assets. For analyses of these methods, see United Nations Economic Commission for Europe, Series: Investment Promotion, *Intellectual Assets: Valuation and Capitalization*, United Nations Publications, Geneva and New York, 2003, at 1-173, and Gordon V. Smith et al, *Valuation of Intellectual Property and Intangible Assets (2000)*, at Chapter 13. Notably, option pricing theory was primarily developed for use in the financial markets but has been extended to evaluate intangible assets also. The key paper on option pricing theory is Fischer Black et al, 'The Pricing of Options and Corporate Liabilities', 81 *Journal of Political Economy* 637 (1973), at 637-654.

[1539] See e.g., OECD, *Discussion Draft; Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*, 6 June to 14 September 2012, OECD, Paris, 2012, at par. 109: *"The application of income- based valuation techniques, especially valuation technique premised on the calculation of the discounted value of projected future cash flows, may be particularly useful when properly applied and when based on appropriate assumptions."* Cf. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Chapter VI at par. 6.20, and OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Guidance on Transfer Pricing Aspects of Intangibles*, Paris, 16 September 2014, at 78 et seq. Notably, see Toshio Miyatake, 'General Report – Transfer Pricing and intangibles', in International Fiscal Association, *Cahiers de droit fiscal international* (2007) 17, at 34, setting forth that the income approach (relative to the market approach and cost approach), particularly the discounted cash flow method is most frequently used in practice. Further, see Christopher J. Faiferlick et al, 'Using Real Options to Transfer Price Research-based Intangibles', 7 *Derivatives and Financial Instruments* 43 (2005), at 43-47.

[1540] See Gordon V. Smith et al, *Valuation of Intellectual Property and Intangible Assets (2000)*, at Chapter 6. Yariv Brauner, 'Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes', 28 *Virginia Tax Review* 81 (2008).

[1541] Please note that the commercial records of firms may not be that helpful either. Financial accounting standards such as US GAAP and IFRS typically use cost based accounting methods to assess company values. These reflect the cost approach where value is measured by reference to the costs that are necessary to recreate the property that is being valued. Yet, as cost does not explain profit and with that value, the 'value gap' also arises in commercial accounting, i.e., the difference between the firm's equity in its balance sheets and its market value. Typically, the firm's crown jewels, often not included in the financial statements, are responsible for the value gap. See on this matter Gordon V. Smith et al, *Valuation of Intellectual Property and Intangible Assets (2000)*, at Chapter 5.

[1542] See Stanley I. Langbein, 'The Unitary Method and the Myth of Arm's Length', 30 *Tax Notes* 625 (17 February 1986), at 660. Further, see Richard M. Bird, 'The Interjurisdictional Allocation of Income', 3 *Australian Tax Forum* 333 (1986), at 334, who argues that the unitary nature of the multinational entity makes it impossible to define an objective and determinative profit allocation standard. See further Reuven S. Avi-Yonah et al, 'Formulary Apportionment – Myths and Prospects; Promoting Better International tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative', 3 *World Tax Journal* 371 (2011), at 380 who set forth that there is no one metric that explains the opaque process through which MNEs generate profit. See also Michael J. McIntyre, 'The Use of Combined Reporting by Nation States', in Brian J. Arnold et al eds., *The Taxation of Business Profits Under Tax Treaties* (2003) 245, at 260 who argues that income does not have a true source and, therefore, any quest for finding it is futile. Finally, see Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 700 and 712, who sets forth that 'the basic problem is that it may be impossible, even conceptually, to identify that part of a multinational company's income which is generated in the home (or, indeed, any other) country.' *"Attempting to tax that part of the multinational's income which is due to the central management – as opposed to any operational activities – requires*

style of Hellerstein, in the end, the resolution of that question may be more a matter of faith than of logic.[1543]

Should we have faith in splitting profits by means of subjective income-based valuation techniques? I tend to answer this question in the negative. Perhaps the required forecasting of future events and the subjectivities necessarily leaking in as a consequence may perhaps not be considered too problematic where it concerns business transactions in the market. However, the converse should hold true in my view when it concerns the imposition of tax – i.e., the democratically legitimized obligation to monetarily contribute to the financing of public expenditure. The subjectivities involved cause legal uncertainties and increased compliance costs. Several countries do not accept profit split methods or subject their application to extreme transfer pricing scrutiny. [1544] In practice, the subjectivities cause controversies and disputes as the parties involved may have different views on the appropriate division of the multinational's overall profit, and with that, the amounts of tax payable in the countries involved.[1545] Controversy may not only arise in the relationship between taxpayers and the tax authorities of countries, but also among the tax authorities of the countries involved.[1546] The latter perhaps even at the expense of the multinational concerned.[1547] Some commentators suggested to resolve things pragmatically and settle the matter and establish single taxation through binding bilateral or multilateral advance pricing agreements.[1548] This, nevertheless still does not answer the question of what kind of profit split to agree upon in such 'MAP-APAs'.

As a consequence of the inherent subjectivities involved, it seems that the profit split to be agreed upon in the end revolves around the powers that the parties – i.e., the taxpayer and the tax authorities of the countries involved – bring to the bargaining table.[1549] The battle for

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a value to be given to those activities which is extremely difficult to identify. Further, the multinational company may even make higher profit because it operates globally – being able to exploit different factors in different countries. If so, the requirement to allocate its profits between jurisdictions may have no underlying conceptual basis at all."

[1543] See Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 104. Hellerstein argues that the true source of income may be impossible to identify.

[1544] See Wagdy M. Abdallah et al, 'Transfer Pricing Strategies of Intangible Assets, E-Commerce and International Taxation of Multinationals', 32 *International Tax Journal* 5 (2006), at 11.

[1545] See Michelle Markham, 'Tax in a Changing World: The Transfer Pricing of Intangible Assets', 40 *Tax Notes International* 895 (5 December 2005), at 901.

[1546] Michelle Markham, 'Tax in a Changing World: The Transfer Pricing of Intangible Assets', 40 *Tax Notes International* 895 (5 December 2005), explains at 896 that *"[t]he potential for controversy is heightened when intangible assets are involved because of their often unique nature…"*

[1547] See Michelle Markham, 'Tax in a Changing World: The Transfer Pricing of Intangible Assets', 40 *Tax Notes International* 895 (5 December 2005), at 895-906. Illustrative is the infamous GlaxoSmithKline case, which Markham mentions also. The case involved a transfer pricing dispute between the drug company GlaxoSmithKline and the US and British tax authorities. Both the US and Great Britain considered that the firm rents were essentially driven by functions performed within their jurisdictions. This triggered a multi-billion dollar amount of economic double taxation. In the end, the matter was settled, however, at the expense of GlaxoSmithKline who ended up paying tax twice regardless. The double tax convention between the US and Great Britain does not provide for an arbitration procedure.

[1548] See Michelle Markham, 'Tax in a Changing World: The Transfer Pricing of Intangible Assets', 40 *Tax Notes International* 895 (5 December 2005), at 906: *"APAs may be an ideal vehicle for that innovation, because they can be made to suit individual fact scenarios."* See for a comparison Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 548, who refers to the pursuing of negotiating advance pricing agreements on a bilateral or multilateral basis. Further see Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation', *University of Michigan Law School*, *John M*, *Olin Center for Law & Economics*, Working Paper No. 07-017 (2007). Notably, Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), defines an APA, at 830: *"An APA is an agreement between a taxpayer and the tax authorities whereby the parties agree on a particular transfer-pricing methodology to be applied to a specific set of transactions for a specified term. An APA can be unilateral or multilateral. Unilateral APAs are agreements between a taxpayer and one tax authority; multilateral APAs are agreements between a taxpayer and several tax authorities. APAs are allowed by the OECD guidelines and are used in Canada, the United States, and many other countries".* For some further comments of the OECD on APAs, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par.4.123-4.165, and its Annex to Chapter IV: *Guidelines for Conducting Advance Pricing Arrangements under the Mutual Agreement Procedure ("MAP APAs")*. For an overview, e.g., of the Luxembourg policy for issuing APAs to group companies performing intra-group financing activities, see Frank van Kuijk et al, 'The Luxembourg Financing Circular: Something New on the Horizon?', 39 Intertax 626 (2011, No. 12), at 626-637.

[1549] Cf. Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 839: *"[T]he uncertainty created by the arm's-length principle often benefits a country that has a relatively sophisticated and more aggressive tax administration".* Li proceeds and refers to Charles Irish calling this

the profits may ultimately be won by the economically strongest and, perhaps, the most aggressive negotiator at the bargaining table.

In my view, that cannot produce a fair division of tax.[1550] One should not forget that taxation needs to be democratically legitimized. The profit division processes as described in the above occurs outside the public eye. That is also because privacy laws are typically in place in countries to protect the interests of individual taxpayers. Regardless, as clear standards are absent, subjectivities leak in, which may have as a consequence that the bargaining powers of the parties at the table ultimately affect the profit division and with that the tax revenue of a country. Particularly considering the volumes of potential tax revenues at stake, this reality may be considered *"not healthy for the tax system"*.[1551]

6.3.4.6 Perhaps tax allocation should rely on predetermined formulae; towards formulary apportionment

The recognition of these fundamental downfalls of transfer pricing has lead scholars to advocate the approach of splitting multinational (residual) profits by reference to predetermined formulae, a set of fixed factors.[1552] Such a split could be made available for application on a global basis,[1553] or – the second-best alternative – on a regional basis (i.e., e.g., North American Free Trade Association, European Union, et cetera).[1554] Accordingly, the

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"the other harmful tax competition". See Charles R. Irish, 'The Other Harmful Tax Competition: Why a Few Countries Have Expanding Tax Bases, While Most Have Eroding Tax Bases', 24 *Tax Notes International* 901(2001), at 901-909. Li: *"Irish argues that aggressive US transfer-pricing practices often hurt opposing governments. The result is a troubling erosion of the tax base of weaker countries. In practice, MNEs would be more willing to enter into APAs with a dominant tax administration in order to avoid onerous penalties or adverse transfer pricing adjustments."* See also Hubert M.A.L. Hamaekers, 'Arm's Length - How Long?', 8 *International Transfer Pricing Journal* 30 (2001), at 30.

[1550] See for a comparison Steve Christensen, 'Formulary Apportionment: More Simple – On Balance Better', 28 *Law and Policy in International Business* 1133 (1996-1997). At 1158, Christensen considers APAs expensive and intrusive, even unneeded as there is an alternative: formulary apportionment. He further refers to the unavailability of MAP-APAs to smaller businesses that desire to conduct international transactions through related entities. In addition, in 'the very existence of 'stamp approval of APA', Christensen sees an illustration of the 'failure of ALS in the US tax system to develop concrete and reliable standards'.

[1551] See Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', *2 World Tax Journal* 3 (2010), at 3-18 and at 9.

[1552] See the references in the following two footnotes. See also Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', *2 World Tax Journal* 3 (2010), at 3-18. Avi-Yonah proposes a compromise, a hybrid ALS/FA-system at 3: *"Use FA in the context of the ALS. Specifically, I would suggest using FA to allocate the residual profit in the profit split method"*. Further, see Michael Mazerov, 'Why arm's length falls short', 5 *International Tax Review* 28 (1994), at 30.

[1553] See Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002). Notably, Li seems to (purposely) employ the term 'global profit split' not in the typical meaning of profit split as commonly used in transfer pricing, but actually to propose some form of formulary apportionment, i.e., allocation on the basis of a formula reflecting the economic factors that contribute to profit making. Also Cockfield mentions this, see Arthur J. Cockfield, 'Formulary Taxation versus the Arm's Length Principle: The Battle Among Doubting Thomases, Purists, and Pragmatists', 52 *Canadian Tax Journal* 114 (2004), at 115. Further, see Nobert Hezig et al, 'Between extremes: Merging the Advantages of Separate Accounting and Unitary Taxation', 38 *Intertax* 334 (2010), at 334, who make a plea for employing ALS for routine transactions and to supplement it with FA where necessary, thereby benefitting from the advantages of both attribution methodologies while to some extent limiting their disadvantages. Further, see François Vincent, 'Transfer Pricing and Attribution of Income to Permanent Establishments: the Case for Systematic Global Profit Splits (Just Don't Say Formulary Apportionment)', 53 *Canadian Tax Journal* 409 (2005), at 409.

[1554] For a proposal to adopt a formulary approach on the level of NAFTA, see, e.g., Paul R. McDaniel, 'Formulary Taxation in the North American Free Trade Zone', 49 Tax Law Review 691 (1993-1994), at 691-744. Also Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 843, refers to McDaniel. See further Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, who mentions the alternative of employing formulary approaches at regional levels as well (North American Free Trade Association, European Union), i.e., at 246 and 293-293. McIntyre further refers to Robert S. McIntyre and Robert S. McIntyre et al, 'Using NAFTA to Introduce Formulary Apportionment', 6 *Tax Notes International* 851 (5 April 1993), at 851-856, and Mike McIntyre, 'Harmonizing Direct Taxes in the EEC', 2 *Tax Notes International* 131 (1990), at 131-132. See also Alicia Munnell, 'Taxation of Capital Income in a Global Economy: An Overview', *New England Economic Review* 33 (1992), at 33-51, and Charles E. McLure, Jr., 'Economic Integration and European Taxation of Corporate Income at Source: Some Lessons from the U.S. Experience', 29 *European Taxation* 243 (1989), at 243-250. The application of a formulary approach on regional bases, sometimes referred to as 'water's edge', may perhaps be pragmatically and politically more feasible than its global alternative. However, regional approaches trigger profit allocation issues at the regional borders. That is, since at these borders SA/ALS would apply, thereby analytically re-introducing the issues accompanying its use in a manner as elaborated upon extensively in the above subsections. Cf. Charles E. McLure

next analytical step in the 'profit allocation continuum' has been taken: the introduction of formulary approaches into the analysis.

Worth noting is that the OECD explicitly rejects formulary approaches as they consider predetermined formulae to be unable to produce arm's length outcomes.[1555] Implicitly, the OECD does allow for fractional approaches on *ad hoc* bases in specific circumstances.[1556] Further the OECD sees some room for adopting safe harbors, i.e., an approach that essentially resembles a formulary allocation on a predetermined basis.[1557]

Conversely, the US shows less reluctance with formulary approaches. Its proposed global dealing regulations, for instance, provide that 'in appropriate circumstances, the use of a multifactor formula is allowed to determine an arm's length allocation of combined profits in a global trading situation'.[1558] In addition, under the available 50/50 method, the US uses a two-factor property and sales formula to apportion income from the production and sale of goods.[1559] Perhaps the conceptually more relaxed views on the matter may be explained by

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Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 258.

[1555] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 1.15. and section C. Cf. Michelle Markham, *The Transfer Pricing of Intangibles* (2005), at 147, Markham also sets forth that the OECD does not reject fractional approaches as such, but specifically the use of predetermined formulae.

[1556] See for a comparison *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 2.132. As regards to the application of the profit split method, the OECD explicitly forwards that it is not desirable to establish a prescriptive list of criteria or allocation keys. Understandably, as the adoption of predetermined allocation keys would basically introduce formulary apportionment. Indeed, formulary apportionment systems exactly resort to prescriptive allocation keys (payroll, assets, sales). Moreover, formulary approaches may also be recognized to be authorized by the OECD under the indirect-charge methods regarding certain intra-group service provisions provided, e.g., by parent companies or group service centers. Indirect-charging may occur on the basis of allocation keys by reference to turnover, staff employed. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 7.23-7.25. Also in respect of cost contribution arrangements ('CCAs') the OECD authorizes formulary approaches referring to sales, units used, produced or sold, gross or operating profit, the number of employees, capital invested, and so forth. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 8.3 and 8.19. Cf. David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 1: The Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 55 (2004), at 67. Further, see OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at par. 211-215 regarding CCAs, and 216-220 regarding internal services. On US perspectives on cost sharing arrangement, see 26 CFR 1.482-7. Notably, the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par.8.3 defines CCAs as follows: *"A CCA is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights. A CCA is a contractual arrangement rather than necessarily a distinct juridical entity or permanent establishment of all the participants. In a CCA, each participant's proportionate share of the overall contributions to the arrangement will be consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement, bearing in mind that transfer pricing is not an exact science."* For some further reading and analysis, see Theresa Stradinger, 'Classification of Cost Allocation Agreements', 41*Intertax* 665 (2013), at 665-675.

[1557] Worth mentioning, is OECD, *Discussion Draft; Revision of Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines and Draft Sample Memoranda of understanding for Competent Authorities to Establish Bilateral Safe Harbours*, 6 June to 14 September 2012, OECD, Paris, 2012. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, at par. 4.93-4.122. In these documents the OECD argues that for administrative convenience reasons, states may consider to adopt safe harbor transfer pricing rules. In the view of the OECD caution should be taken, though, as safe harbor rules theoretically do not coincide with the arm's length standard. The OECD arrives at the conclusion that the adoption of safe harbor rules may be worthwhile in straightforward cases. Interestingly, this begs the question that if the case at hand is straightforward, why should states resort to safe harbor rules in such straightforward cases in the first place?

[1558] See 26 CFR 1.482-8(e)(2) in conjunction with Notice 94-40 (*Global Trading Advance Pricing Agreements*, 1994-1 C.B. 351, 25 April 1994) published by the US Internal Revenue Service. The notice provided a generic description of the experience of the IRS with functionally integrated global dealing operations. See also the IRS's *Proposed Regulations on Arm's Length Allocation of Income From Global Dealing Operation* (REG-208299-90), (3 June 1998). For some analysis on this matter, see Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 830. Worth noting is that the OECD in its profit attribution report sees room for adopting the profit split method, i.e., a quasi-formulary approach in cases involving the commercialization of intangibles in relation to integrated global trading business operations. See OECD, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, at par. 204.

[1559] See US IRC section 863 and 26 CFR 1.863. See on this also Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 264. Notably, see Office of Chief Counsel, Internal Revenue Service, *Memorandum*, Number:

reference to the common use of formulary apportionment systems in the US to divide state income tax bases between the states.

Notably, in the process, the alleged analytical gap between ALS and formulary apportionment ('FA') has been bridged.[1560] The analytical difference between the profit split transfer pricing method and formulary apportionment does not seem that big. The approaches are conceptually much alike. Both, for instance, approximate the geographical source of income by reference to a formula. The profit split essentially differentiates from formulary apportionment at only one point. The profit split utilizes formulae by reference to firm specific inputs which are assessed at the time of investment. FA splits profit by reference to a predetermined formula, for instance on the basis of payroll, assets and sales.

The question arises as to which factors to put into such a formula. Indeed, the time has come to take a closer look at formulary apportionment. Notably, as will be shown, again a conceptual crossroads shall emerge, i.e., the question as to whether to attribute profits to the origin state, to the destination state, or to both.

6.4 Tax pie sharing under the supply-demand and demand-side alternatives: 'Formulary Apportionment'

6.4.1 Traditional FA aims at fairly approximating the location and value of firm inputs at origin and firm outputs at destination

The traditional formulary systems seek to allocate taxing entitlements to the tax jurisdictions of both origin and destination. They seek to do this by fairly approximating the location and value of firm inputs and outputs on the basis of a predetermined fixed formula.[1561] Formulary

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20051001F (Release Date: 3/11/2005), at 4: *"Under the 50/50 method, 50% of the gross income from Section 863 Sales is allocated to production activity and 50% is allocated to sales activity"*.

[1560] See for a comparison International Monetary Fund, *IMF Policy Paper; Spillovers in International Corporate Taxation*, International Monetary Fund, Washington, D.C., 2014, at 31, David L.P. Francescucci, 'The Arm's Length Principle and Group Dynamics – part 1: The Conceptual Shortcomings', 11 *International Transfer Pricing Journal* 55 (2004), at 56: *"… smoothly bridging the gap…"*. See also Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation', *University of Michigan Law School*, *John M*, *Olin Center for Law & Economics*, Working Paper No. 07-017 (2007). Avi-Yonah argues that despite the common practice of contrasting the ALS and formulary methods of dealing with the transfer pricing problem, they are actually not dichotomous, but, instead, rather form the two extreme ends of a continuum ranging from the comparable uncontrolled price method to predetermined formulas. Avi-Yonah explains that the profit split method conceptually operates in a manner akin to formulary apportionment as it starts with the profits of the enterprise as a whole and allocates the business income in a formulary fashion. This brings him to forward that the distinction between ALS and FA largely is a matter of semantics, not substance. Also Li refers to this, Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002) at 838. Li argues that the arm's length standard and formulary apportionment should not be viewed as polar extremes, but rather should be viewed as a part of a continuum of methods ranging from CUP to predetermined formulas. Please note that such a conceptualization of the sloping of the transfer pricing methods from ALS to FA has been recognized in a similar manner in the above subsection also. Further, see further Hubert M.A.L. Hamaekers, 'Arm's Length - How Long?', 8 *International Transfer Pricing Journal* 30 (2001), at 37, who recognizes an analytical difference between formulary apportionment and the profit split methods as a consequence of the absence of a predetermined formula under the latter. See also Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 13: *"The main difference between the current application of formulaic methods in international tax law and formulary apportionment as practicised in some subnational apportionment systems appears to be that predetermined formulae are used in the latter but not in current national and international tax law."* Finally and notably, see Reuven S. Avi-Yonah et al, 'Formulary Apportionment – Myths and Prospects; Promoting Better International tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative', 3 *World Tax Journal* 371 (2011), at 371. In this Article, the authors cross the analytical line from basing the residual profit split on firm specific factors (market value of non-routine functions) to splitting the residual by means of a predetermined formula, i.e., a limited formulary apportionment regime. See on the arm's length versus formulary apportionment debate also Wolfgang Schön, 'International Tax Coordination for a Second-Best World (Part III)', 2 *World Tax Journal* 227 (2010), at 227-261.

[1561] See for analyses of the formulary approach, e.g., Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984), Michael Lang et al (eds.), *Common Consolidated Corporate Tax Base* (2008), Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), Charles E. McLure, Jr., 'The State Corporate Income Tax: Lambs in Wolves' Clothing', in Henry J. Aaron et al, *The Economics of Taxation* (1980) 327, at 327-346, Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 243-292, Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, Joann M.

systems essentially seek to localize and evaluate both the production and marketing sides of income generation. Where does the global entrepreneur produce and sell its product?

Contrary to SA/ALS, traditional formulary apportionment recognizes income generation as the outcome of the interplay of both supply and demand.[1562] FA seeks to attribute corporate tax base to both the investment jurisdiction (origin) and the jurisdiction where the firm's goods and services are marketed (destination).[1563] Appreciating that corporate income lacks geographical attributes, formulary systems modestly seek to provide a fair geographical division of income rather than identifying the 'true' geographic source of income.[1564] The weighing of factors accordingly is considered a matter of judgment.[1565] Notably, taxable profit division on the basis of formulary mechanisms conceptually differs from the profit division approaches in international taxation. Internationally, as said, the corporate tax base is sought to allocate income merely by reference to the tax jurisdictions of origin (i.e., the location of firm inputs).

Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, Charles E. McLure, Jr., 'The Elusive Incidence of the Corporate Income Tax: The State Case', 9 *Public Finance Quarterly* 395 (1981), at 395-413, Charles E. McLure, Jr., 'Economic Integration and European Taxation of Corporate Income at Source: Some Lessons from the U.S. Experience', 29 *European Taxation* 243 (1989), at 243-250, Jerome R. Hellerstein, 'Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment', 60 *Tax Notes* 1131 (23 August 1993), at 1136-1145, Joann M. Weiner, 'Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level', 13 *Tax Notes International* 2113 (23 December 1996), Jack M. Mintz, 'Globalization of the Corporate Income Tax: The Role of Allocation', 56 *Finanzarchiv* 389 (1999), at 389-423, Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286, Charles E. McLure Jr., 'Replacing Separate Accounting and the Arm's Length Principle with Formulary Apportionment', 56 *Bulletin for international taxation* 586 (2002), at 587, Charles E. Mclure, Jr., 'Corporate Tax Harmonization in the European Union: The Commission's Proposals', 36 *Tax Notes International* 45 (4 October 2004), at 45-69, Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 199-220, Walter Hellerstein et al, 'Lost in Translation: Contextual Considerations in Evaluating the Relevance of US Experience for the European Commission's Company Taxation Proposals', 58 *Bulletin for international taxation* 86 (2004), at 86-98, Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 103-111, Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, and Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

[1562] Cf. Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 228-246.

[1563] It would be consistent to apportion both profits as losses. However, the CCCTB for instance only apportions profits under the sharing mechanism, see Article 86(2) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). Losses are carried forward on a non-shared basis. This creates complexities where mergers and acquisitions are involved in the presence of ring-fenced loss carry forwards. These need to be geographically divided to make sure that CCCTB losses do not cross European Union Member State tax borders, see Chapters X and XI Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). See on this matter Jan van de Streek, 'The CCCTB Concept of Consolidation and the Rules on Entering a Group', 40 *Intertax* 24 (2012), and Jan van de Streek, 'The CCCTB Rules on Leaving a Group', 40 *Intertax* 421 (2012). This is not further discussed in this study, as in my view, the matter may be circumvented easily by apportioning losses prior to the application of a carry forward mechanism. In that case, the issue would not rise in the first place.

[1564] Cf. e.g., Michael J. McIntyre, 'The Use of Combined Reporting by Nation States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits Under Tax Treaties* (2003) 245, at 253, Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 104, and Peggy B. Musgrave, 'Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union, Issues and Options for Reform* (2000) 46, at 46-77.

[1565] Cf. Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 33. See for a comparison Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 6 (par. 13): *"The Commission Services consider that the weighting of the factors is not a technical issue and recommend that any discussion on the weighting be carried out at political level…"*

6.4.2 Formulary apportionment systems: the US, Canada, and the CCCTB

6.4.2.1 Some well-known examples

The best known examples of countries that have traditionally been utilizing formulary approaches to divide corporate tax bases at subnational levels of government are the US ('formulary apportionment') and Canada ('formulary allocation'). Within the context of the European Union, the European Commission's 16 March 2011 proposal for a Common Consolidated Corporate Tax Base ('CCCTB') envisages a formulary approach to share the European Union-wide corporate profits of European Union businesses among the European Union Member States. Before proceeding, it may be worth briefly addressing some of the basic characteristics of the US, Canadian and CCCTB systems.[1566]

6.4.2.2 Formulary apportionment in US state income taxation: a glance

With regards to the US, the District of Columbia and all the states except Wyoming, Washington, South Dakota and Nevada autonomously employ a state corporate income tax system. State income taxes are imposed in addition to the federal income tax that is levied from corporations at a marginal rate of 35%. The state tax rates roughly differentiate between 5% and 10%.

The US states' practices of using formulary mechanisms to divide the corporate profits of multistate (unitary) businesses to the taxing jurisdictions in which they have a business connection operate within a framework of mutually diverging state income tax systems. Each US state operates its own system. The states' autonomy to levy state income taxes on corporations is constrained by federal statutes[1567] and the jurisprudence of the Supreme Court of the United States which sets forth the constitutional limitations of the states' autonomy in taxation.[1568-1569] The field of US state income taxation is characterized by a high degree of non-uniformity. Although the federal corporate tax base is used by most states as a

[1566] Other countries employing formulary systems at sub-national levels of government include Germany and Switzerland. These are not further discussed. For analyses and comments, see Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), Chapter 3, paragraphs 3.4 and 3.5.

[1567] See for instance 15 USC §381. This provision – often referred to by its 1959 enacting legislation as U.S. Public Law (PL) 86-272 – requires the physical presence (e.g., a branch or office) of an out of state remote seller of physical goods situated within a state to establish its taxable presence for state income tax purposes. This legislation has been enacted in response to an US Supreme Court case basically constitutionally validating the establishing of a taxable presence for state income tax purposes of an out of state remote seller lacking an in-state physical presence, see *Northwestern Cement Co. v. Minnesota*, 358 U.S. 450 (1959). Worth noting further is the Business Activity Tax Simplification Act of 2011 (HR 1439) that was introduced to Congress on 8 April 2011 but had never been taken up by the broader chamber upon its passing of the House Judiciary Committee on 7 July 2011 before Congress ended its session. The Bill would expand the provisions of PL 86-272 (including the physical presence requirement for a business to be subject to state income tax) to apply also to services and intangibles.

[1568] The relevant clauses in the US Constitution are the Due Process clause and the Commerce clauses (U.S. Constitution, amendment XIV, section 1 and U.S. Constitution, article I, section 8, cl. 3. Some key rulings of the United States Supreme Court are *Miller Brothers Co. v. Maryland*, 347 U.S. 340 (1954), *Complete Auto Transit, Inc. v. Brady, Chairman, Mississippi Tax Commission*, 430 U.S. 274 (1977), *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 98 S. Ct. 2340 (1978), *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983), *Tyler Pipe v. Wash. Dept. of Rev*., 483 U.S. 232 (1987), *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), and *Barclays Bank PLC v. Franchise Tax Board of California*, 512 U.S. 298 (1994). Also worth noting is the Supreme Court of South Carolina in *Geoffrey Inc. v. South Carolina Tax Commission,* 437 S.E. 2d 13 (1993) with respect of which the Supreme Court denied certiorari (510 US 992 (1993). On the unitary business definition, see *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S. Ct. 1223 (1980), *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 228, at 222-223, 100 S. Ct. at 2109 (1980), *Asarco Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982), *F.W. Woolworth Co. v. Taxation and Revenue Dept. of the State of New Mexico*, 458 U.S. 354 (1982), and *Allied-Signal, Inc. ex rel Bendix Corp. v. Director, Div. of Taxatio*n, 504 U.S. 768 (1992).

[1569] Notably, US constitutional law further requires the states to distinguish between so-called business income and non-business income. Apportionment by formula only applies with regards to the former. Non-business income is allocated to taxing jurisdictions directly on the basis of sourcing rules. This matter is not further discussed for the making of such a distinction – although required under US constitutional law – analytically is irrelevant. Cf. Walter Hellerstein, 'The Business-Nonbusiness Income Distinction and the Case for Its Abolition', 21 *State Tax Notes* 725 (September 3, 2001), at 725-739, and Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), 199-220, at 217. See for a comparison Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 7 (par. 15). Neither the Canadian system nor the CCCTB proposal, e.g., makes such a classification.

starting point for state tax base calculation purposes, many states subsequently adopt alterations, for instance, by way of tax incentives to implement their individual social and economic tax policies (accelerated depreciation, tax credits, et cetera).[1570] Furthermore, each state uses its own formula or sets of formulae.[1571] Industry specific formulae apply to particular sectors of industries (e.g., construction, transportation, television and broadcasting, financial institutions).[1572] To attract investment, some states allow taxpayers to choose out of a variety of formulae.[1573] State taxes are deductible for US federal income tax purposes.[1574]

Harmonization efforts have been made in the US by the Multistate Tax Commission, i.e., an advisory intergovernmental state tax agency created in 1967 by the Multistate Tax Compact. The compact provides for a model state income taxation statute. It incorporates nearly verbatim the Uniform Division of Income for Tax Purposes Act (UDITPA), a model which was promulgated by the Uniform Law Commission in 1957.[1575] The Multistate Tax Commission also provides for non-binding recommendations of best practice. The Multistate Tax Commission is currently in the process of discussing revisions to the compact.[1576] The traditional equally-weighted three-factor 'Massachusetts formula' (1/3 tangible assets and rental expense, 1/3 sales and other receipts, and 1/3 payroll),[1577] which spread among the US states in the 1950s upon the promulgation of UDITPA, is being debated. Following developments in states practices, it has been suggested to increase the weight on the sales factor. That is to arrive at a double-weighted gross receipts factor (1/4 payroll, 1/4 capital, 1/2 sales).[1578] Thirty-seven US states follow all or parts of UDITPA.[1579] US states increasingly turn to destination based sales-only FA in attempting to attract investments and employment into their territories.[1580]

6.4.2.3 Formulary allocation in Canadian provincial/territorial tax system: a glance

In Canada, the ten provinces and the three territories levy corporate income taxes. These are imposed in addition to the Canadian federal corporation tax. The Canadian system is characterized by a high degree of harmonization.[1581] This has been achieved through the tax collection agreements ('TCAs') that have been concluded by the Canadian federal

[1570] See Michael Daly et al, 'Corporate Tax Harmonization and Competition in Federal Countries: Some Lessons for the European Community?', 46 *National Tax Journal* 441 (1993), at 447, and Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 86.
[1571] For an overview of the formulae adopted by the US States as of January 1, 2013, see David Spencer, 'Unitary taxation with combined reporting: The TP solution?', *International Tax Review*, 25 April 2013, at 2-5.
[1572] This is not further discussed. For some further reading, see Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 25, and Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 58-59.
[1573] See for some examples, Chris Kelling, 'Arizona Governor Vetoes Corporate Credit for Tuition Donations, OKs Superweighted Sales Factor', 36 *State Tax Notes* 632 (30 May 2005), at 632-633, and Chris W. Courtwright, 'Governor Approves Single-Sales-Factor Apportionment Incentive', 44 *State Tax Notes* 16 (2 April 2007), at 16.
[1574] Sec. 164 of the US IRC.
[1575] For some historical notes, see John S. Warren, 'UDITPA – A Historical Perspective', 38 *State Tax Notes* 133 (3 October 2005), 133-136.
[1576] See Multistate Tax Commission, *Multistate Tax Compact Article IV - Recommended Amendments*, 3 May 2012, at 10-14, and Multistate Tax Commission, *Multistate Tax Compact Article IV Recommended Amendments As approved for Public Hearing,* 6 December 2012.
[1577] Article IV.9 Multistate Tax Compact.
[1578] See Multistate Tax Commission, *Multistate Tax Compact Article IV - Recommended Amendments*, 3 May 2012, at 10-14, and Multistate Tax Commission, *Multistate Tax Compact Article IV Recommended Amendments As approved for Public Hearing,* 6 December 2012.
[1579] See Multistate Tax Commission, *Multistate Tax Compact Article IV - Recommended Amendments*, 3 May 2012, at 3, referring to Commerce Clearing House, ¶ 11-505, 25 April 2012.
[1580] See David Spencer, 'Unitary taxation with combined reporting: The TP solution?', *International Tax Review*, 25 April 2013, at 2-5.
[1581] See Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 108, Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 4, Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 44.

government and the provinces, with the exceptions of Quebec and Alberta, and the historical developments that led to the conclusion of these TCAs.

The Canadian system may be described as a 'piggyback' one.[1582] The TCAs provide that the provinces levy corporate tax from corporations that have Canadian nexus on taxable income as defined under the federal act. The interprovincial/territorial allocation of corporate profits to permanent establishments occurs by reference to a harmonized, equally-weighted two-factor formula (1/2 payroll, 1/2 gross revenue).[1583] Similar to practices in the US, Canada has adopted sector specific formulae as well.[1584] No capital factor is used. In exchange for adhering to the federal statutes, the Canada Revenue Agency, i.e., the federal tax collecting agency, collects the provincial taxes free of charge on behalf of these provinces through a system of unified tax returns at tax rates specified by the provinces. The sub-national levels of government, however, remain autonomous in deciding the applicable tax rates, and the use of tax credits to the post-allocated tax base for the purposes of setting tax policy.[1585] The provincial tax rates generally range between 10% (Alberta) and 16% (Prince Edward Island / Nova Scotia). Quebec and Alberta operate and collect their own tax and accordingly have some flexibility in the design of their tax system. However, generally, these provinces adopt a tax base definition and allocation formula that is very similar to their Canadian counterparts.[1586]

The Canadian tax system has upheld its uniformity. Businesses have come to accept the benefits of harmonization.[1587] Moreover, the Canadian system is stabilized and supported by a structure of equalization payments. The Canadian federal government makes funds available to the less wealthy – so-called 'have not' – provinces to equalize their fiscal capacities;[1588] that is, relative to the 'have' provinces who do not receive equalization payments. The sub-national corporation taxes are not deductible from the Canadian federal tax base. Instead, to give room for these taxes, the federal Income Tax Act provides for an abatement of 10% from the basic federal tax rate of 38%.[1589] It basically provides for a deduction from the federal tax otherwise payable of an amount equal to 10% of the corporation's taxable income that is allocated in a tax year to Canadian provinces and territories. The abatement is unavailable for income that is allocable to foreign jurisdictions. Foreign income is not generally subject to provincial or territorial taxes.

6.4.2.4 Formulary apportionment in the EU under the proposed CCCTB: a glance

Within the European Union, the Commission envisages the proposal for a CCCTB to constitute 'a comprehensive solution' for the inequities and inefficiencies that are currently present under the application of the twenty-eight different corporate tax systems in the European Union.[1590] Under the Commission's proposal, the CCCTB would operate electively,

[1582] See Nicholas D. LePan, 'Comments on Musgrave', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 247, at 247-249.
[1583] See Sec. 402(3) Canadian Income Tax Regulations.
[1584] See Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 25, and Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 58-59.
[1585] The provinces make use of tax credits to attract investment. See Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at Chapter 6, and at Joan Martens Weiner, 'CCCTB and Formulary Apportionment: The European Commission Finds the Right Formula', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 253, at 265.
[1586] Reference is made to See Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 117.
[1587] See Joan Martens Weiner, 'CCCTB and Formulary Apportionment: The European Commission Finds the Right Formula', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 253, at 265.
[1588] Sec. 36(2) Constitution Act 1982. See Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 63 and 113.
[1589] See Sec. 124 Canadian Income Tax Act.
[1590] European Commission, 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*, COM(2001) 582 final, 23 October 2001, and Communication from the Commission to the Council, the European Parliament and the European

i.e., as an available alternative to the corporate tax systems of the European Union Member States.[1591] The CCCTB would accordingly constitute the 29th corporate tax system within the European Union.

In addition to the formulary approach to divide corporate profit within the European Union, the CCCTB proposal's key properties are the tax consolidation of affiliated corporate entities that have nexus within the European Union, and the harmonized taxable base definition to calculate the tax consolidated group's European Union-wide corporate profits.[1592] The intra-European Union division of the group's common tax base occurs through a sharing mechanism, which echoes the 'Massachusetts formula' under UDITPA. Also the CCCTB proposal makes use of an equally-weighted three-factor formula (assets, payroll, sales).[1593] The European Commission explicitly remarks that *"the transfer prices which are calculated for tax purposes no longer serve any underlying commercial rationale in the Internal Market".*[1594] No industry specific formula variant has been proposed for technical and administrative convenience reasons.[1595] This is the case regardless of the fact that a 'safeguard clause' has been introduced, which is directed at correcting unfair outcomes under the application of the general formula.[1596] The CCCTB proposal does not allow for European Union Member States making use of tax credits to reduce post-apportioned tax base.[1597]

Economic and Social Committee, *An Internal Market without company tax obstacles achievements, ongoing initiatives and remaining challenges*, COM(2003)726 final, 24 November 2003.

[1591] See Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). European Parliament and the European Economic and Social Committee have voted in favor of a mandatory CCCTB (after an introductory period). See European Parliament on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB), (COM(2011)0121 – C7-0092/2011 – 2011/0058(CNS)), A7-0080/2012, 28 March 2012, Amendments 14, 21, 22; changes proposed to recital 8, Article 6a (new) and Article 6b (new), and Opinion of the European Economic and Social Committee on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121 final – 2011/0058 (CNS), ECO/302, 26 October 2011, at 1.3.

[1592] See Chapter X Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).

[1593] See Article 86(1) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). European Parliament proposed to increase the weight on inputs (labor: 45%, assets: 45%) and reduce the weight on outputs (sales: 10%), see the European Parliament on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB), (COM(2011)0121 – C7-0092/2011 – 2011/0058(CNS)), A7-0080/2012, 28 March 2012, Amendments 16 and 31; changes proposed to recital 21 and 86. The Commission cannot accept the amendment, Commission Communication on the action taken on opinions and resolutions adopted by Parliament at the April 2012 part-session, (SP(2012)388), 30 May 2012, considering an equally-weighted three factor formula the most appropriate solution.

[1594] See European Commission, 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*, COM(2001) 582 final, Brussels, 23 October 2001, at 39.

[1595] See for some analysis e.g., Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 17 (par. 69-70), and Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 9 (par. 19). See further Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 52, *An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB*, Taxud E1 AAG-GR-FF, CCCTB\WP\052\doc\en, Brussels, 27 February 2007, at 10 (par. 47): *"Few experts commented on this point, mainly considering that there should be as little differences as possible, the financial sector being one potential candidate to a 'special' formula".* The introduction of industry specific formulae would produce qualification issues and demarcation problems to the extent that a horizontally integrated firm would engage into business operations falling under diverging formulae.

[1596] See Article 87 Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). The safeguard clause applies save for unanimity consensus of the European Union Member States' authorities involved.

[1597] European Parliament has voted in favor of introducing the possibility for European Union Member States to make use of tax credits to reduce post-shared tax base. That is, to enable them to *"adopt certain incentives for businesses"*. See European Parliament on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB), (COM(2011)0121 – C7-0092/2011 – 2011/0058(CNS)), A7-0080/2012, 28 March 2012, Amendment 9; changes proposed to recital 5. The Commission has submitted that it cannot accept this amendment for technical reasons. See Commission Communication on the action taken on opinions and resolutions adopted by Parliament at the April 2012 part-session, (SP(2012)388), 30 May 2012. Research on equivalents in the Canadian formulary allocation system suggests that such a tool would likely initiate tax competition between European Union Member States for intra-European Union investment. See Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at Chapter 6. In my view, the utilization of tax credits for certain businesses entails the risk of triggering fiscal state aid issues and should therefore be considered a route not to be followed. Cf. Maarten F. de

The CCCTB proposal does not foresee tax rate harmonization. The Commission considers the decisions on the tax rates to remain at the level of European Union Member State sovereignty.[1598] Rate harmonization would likely face political resistance in the European Union Member States as this would involve a substantial transfer of fiscal autonomy from the states to the union.

6.4.3 The virtues of common and theoretically sound approaches, also under FA

6.4.3.1 FA is about profit division, not about tax unit definitions, tax base definitions or double tax relief mechanisms

Formulary apportionment is a methodology used to divide corporate profit among taxing jurisdictions by reference to a predetermined formula that fairly reflects the income-generating activities of a firm within a taxing jurisdiction. Nothing more, nothing less. Analytically, FA has nothing to do with tax unit definitions, tax base definitions, or double tax relief mechanisms. Taxing jurisdictions may even adopt mutually diverging formulae to attribute multijurisdictional profit, as the US state income tax practices show.

This holds true, although formulary apportionment systems have often been associated with a harmonized taxable entity definition; FA is typically coupled with a tax grouping concept like tax consolidation or combined reporting. Formulary apportionment is also sometimes associated with tax base uniformity, territorial taxation and geographic limitations to which the formulary system applies. The latter is generally referred to as the 'water's edge limitation'. These associations, however, are not a conceptual necessity and should accordingly be kept separate analytically.[1599] This has not always been fully appreciated.[1600]

6.4.3.2 A common approach: also under FA

Although the concept of dividing profit by reference to a formula should not be analytically confused with the taxable entity, the tax base and double tax relief mechanisms, this does not mean that a common approach, also under a formulary approach, would not be beneficial.[1601]

Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

[1598] European Parliament proposed to introduce the possibility for future rate harmonization. European Parliament on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB), (COM(2011)0121 – C7-0092/2011 – 2011/0058(CNS)), A7-0080/2012, 28 March 2012, Amendment 10; changes proposed to recital 5a (new). If the CCCTB would apply mandatorily as well, that would effectively introduce a fully centralized 'European Union Company Income Tax' ('EUCIT'). The Commission however has expressed that it cannot accept rate coordination. It considers that the CCCTB proposal is meant not to touch upon tax rates. See Commission Communication on the action taken on opinions and resolutions adopted by Parliament at the April 2012 part-session, (SP(2012)388), 30 May 2012.

[1599] Cf. Michael J. McIntyre, 'The Use of Combined Reporting by Nation States', in Brian J. Arnold et al eds., *The Taxation of Business Profits Under Tax Treaties* (2003) 245, at 249 and 268.

[1600] Cf. Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 21-22 making reference to the need to analytically distinguish between the taxable entity, the taxable base, and the subsequent geographical apportionment of the taxable entity's taxable base. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Chapter I, at par. 1.17: *"Global formulary apportionment would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula."* See e.g., also Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 52, *An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB*, Taxud E1 AAG-GR-FF, CCCTB\WP\052\doc\en, Brussels, 27 February 2007, at 2 (par. 4): *"Apportionment is a necessary consequence of consolidation",* and Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 5 (par. 7): *"The sharing mechanism itself is not the purpose of the comprehensive tax reform, but a necessary and unavoidable consequence of the consolidation"*.

[1601] Cf. Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 287. See for a comparison Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, emphasizing the *"extreme importance of a uniform formula"* at 6 (par. 14).

As mentioned in this study's introduction, the non-uniformity in international corporate taxation triggers double (non-)taxation issues, inequities and investment distortions. This holds true also where formulary apportionment is used to geographically attribute tax base among taxing states rather than SA/ALS. A common approach cancels out hybrid entity and hybrid income mismatches, as well as mismatches in the geographic allocation of the taxable base.[1602]

As regards to the differentials in the US states' income tax systems, various commentators, for example, have argued that the US precedent is a route not to be followed.[1603] Differentials in the apportionment formulae trigger double (non-)taxation within the US, as well as overtaxation and undertaxation of multijurisdictional business operations relative to in-state business activities. This is generally considered inequitable. It also distorts the business decision of whether to invest across the respective US state's tax-border. This holds true regardless of the fact that the US Supreme Court has sanctioned formulae differentials in the US state income tax systems and the resulting double (non-)taxation under the US Constitution.[1604] The US Supreme Court is not institutionally equipped to require uniformity. That would be a matter for US Congress to resolve.[1605] It has been set forth in the literature that *"the similarity of tax bases, brought about by the existence of the federal tax base, seems to be the only really strong point of the present system."*[1606]

It may be argued that only common approaches in international tax law design sufficiently secure single taxation and may accordingly promote global efficiency.[1607] Economic analyses, for instance, provide some evidence suggesting the merits of obtaining agreement on a common profit allocation methodology.[1608] These have argued that the use of a common formula is the most beneficial in terms of optimizing the social welfare of the participating taxing jurisdictions taken together as a whole. Social welfare would be higher under any common formula, regardless of how it is defined, relative to using non-uniform formulae. Worth noting is that this meets the observations of the US state tax authorities close to a century ago: *"there is no right rule of apportionment (…) the only right rule (…) is a rule on which the several states can and will get together as a matter of comity".*[1609]

[1602] Formulae differentials produce double (non-)taxation. Cf. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Chapter 1, at par. 1.22. Matters may be resolved by adopting a common apportionment formula, as for instance is the case in Canada. Also the CCCTB would provide for a common formula.

[1603] See for a comparison, Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 205-206: *"As only uniform formulae are suitable for preventing double taxation, there is nearly universal agreement that identical formulae have to be applied across the European Community to any given company or corporate group",* and Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 44. See also Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 199-220, and Walter Hellerstein et al, 'Lost in Translation: Contextual Considerations in Evaluating the Relevance of US Experience for the European Commission's Company Taxation Proposals,' 58 *Bulletin for international taxation* 86 (2004), at 86-98.

[1604] See United States Supreme Court, *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 98 S. Ct. 2340 (1978).

[1605] See Jerome R. Hellerstein, 'State Taxation Under the Commerce Clause: the History Revisited', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 53, at 59-60.

[1606] Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 107. See also Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 199-220, at 201.

[1607] Cf. Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 232-233. See also European Commission, 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*, COM(2001) 582 final, Brussels, 23 October 2001, at 15.

[1608] See Bharat Anand et al, 'The weighting game: formula apportionment as an instrument of public policy', 53 *National Tax Journal* 183 (2000), at 183-199, as well as Austan Goolsbee et al, 'Coveting thy neighbor's manufacturing: The dilemma of state income apportionment', 75 *Journal of Public Economics* 125 (2000), at 125-143. See for a comparison Joann M. Weiner, 'Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level', 13 *Tax Notes International* 2113 (23 December 1996) who refers to the investment location distortions that arise under the present non-harmonization of state formulae in the US.

[1609] National Tax Association, *Report of Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Business*, Proceedings of the National Tax Association, Washington, D.C., 1922, 198-212, at 202.

That is the case even though single jurisdictions may benefit in the short term – although at the others' expense – from individually taking a deviating course by adopting diverging formulae on a stand-alone basis.[1610] The tendencies of the US states to move towards sales-only FA to attract corporate investment towards their jurisdictions supports this argument.[1611] States using sales-only FA promote inbound investments relative to states (also) using origin based formula factors, since firm inputs are being left untaxed under such a destination-based tax base attribution system. Note that in the equilibrium sales-only-FA is neutral towards the investment location decision. That is, as sales-only FA assigns profits only to the jurisdiction of firm outputs by reference to the demand side of income production.[1612] Production locations are irrelevant in this respect. Sales-only FA has emerged in the US since the 1980s upon its constitutional validation by the US Supreme Court in the case of *Moorman*.[1613]

In designing a framework model of taxable profit division by reference to a formulary approach, a coordinated approach such as that used in Canada may accordingly be favored over the approaches lacking uniformity that are used in the US.[1614] Also the Commission in its CCCTB-proposal recognizes the benefits of uniformity and accordingly proposes a harmonized European Union-wide formula to share corporate profit within the European Union.[1615] As shown in the Canadian precedent, a standard of setting fiscal policy would remain within the realm of state sovereignty, also under a common approach, through the autonomy in deciding on the tax rates to be applied to the post-apportioned tax bases.[1616] Illustratively, within the context of the European Union, the European Commission is considering that *"[t]he determination of tax rates is treated as a matter inherent in Member States' tax sovereignty and is therefore left to be dealt with through national legislation."*[1617]

6.4.3.3 Unlimited taxation, Dutch-style double tax relief: also under FA

At this place some brief comments are worth making linking the previous chapters with a formulary approach to divide profit across taxing jurisdictions.

In Chapter 3, I made a plea for adopting unlimited taxation for all corporate taxpayers having a business connection with a taxing jurisdiction.[1618] That is, regardless of their place of tax

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[1610] *Ibidem*.
[1611] See Kelly D. Edmiston, 'Strategic Apportionment of the State Corporate Income Tax', 55 *National Tax Journal* 239 (2002), at 239-262.
[1612] See for a comparison Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 12.
[1613] In United States Supreme Court, *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 98 S. Ct. 2340 (1978), the US Supreme Court sustained the Iowa sales-only formula. The assessed Iowa formulary system attributed income solely by reference to the ratio of sales to customers in Iowa to total sales. In the view of Jerome Hellerstein, the US Supreme Court should have invalidated the Iowa apportionment method for it being discriminatory against out-of-state manufacturers. That is, since Iowa manufacturers who sell their goods outside Iowa were tax-favored over out-of-state manufacturers selling their goods in Iowa. See Jerome R. Hellerstein, 'State Taxation Under the Commerce Clause: the History Revisited', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 53, at 60.
[1614] Cf. Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 243-292, Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 199-220, and Walter Hellerstein et al, 'Lost in Translation: Contextual Considerations in Evaluating the Relevance of US Experience for the European Commission's Company Taxation Proposals', 58 *Bulletin for international taxation* 86 (2004), at 86-98.
[1615] See Article 86(1) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). See also Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, *An Internal Market without company tax obstacles achievements, ongoing initiatives and remaining challenges*, COM(2003)726 final, 24 November 2003, at 23, and Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, emphasizing the 'extreme importance of a uniform formula', at 6 (par. 14).
[1616] Cf. Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 51-52.
[1617] See the Explanatory memorandum to the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS), at section 3.
[1618] See also 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, Maarten F. de Wilde, 'Currency Exchange Results – What If Member States

residence. With respect to these taxpayer's foreign income, double tax relief would subsequently be granted by means of the Dutch-style tax exemption mechanism. There is no reason why such a double tax relief system could not be linked to a formulary system. Conceptually, formulary systems can operate either within a worldwide system or a territorial system. Also, formulary systems analytically could function very well under an approach whereby foreign income is exempt from the tax base (base exemption system), or where the foreign tax is credited against the domestic tax on worldwide income (credit system). This is just like the taxing systems using SA/ALS. Moreover, formulary systems may accordingly also operate under a worldwide system where the domestic tax attributable to the foreign income is credited against the domestic tax on worldwide income, i.e., worldwide taxation of both resident and non-resident corporate taxpayers using the Dutch-style tax exemption mechanism for double tax relief purposes. It should be kept in mind that FA is about profit division, not double tax relief.

The arguments forwarded in Chapter 3 advocating the adoption of worldwide taxation for all taxpayers having local nexus and granting double tax relief by reference to the Dutch-style tax exemption mechanism holds up equally under a formulary system as it does under SA/ALS. As extensively discussed, import neutrality promoting exemption systems in the current international tax regime hinder outbound investment, while export neutrality promoting credit systems impair inbound investment. Only the advocated approach of unlimited taxation combined with the Dutch-style tax exemption for foreign income truly secures unilateral tax neutrality and non-discrimination in relation to both inflows and outflows of resources across the tax-borders.[1619] This holds up under the adoption of both SA/ALS and FA for profit attribution purposes. As said, profit allocation methodologies should not analytically be confused with territorial systems or worldwide systems. They should also not be confused with double tax relief mechanisms. That is, as said, for these being analytically separate matters.

6.4.3.4 Economic rent taxation: also under FA

Chapter 5 addresses the issue of tax base design. The formulary systems currently in place in the US and Canada, as well as the proposed CCCTB, compute the corporate taxable base by reference to base definition approaches common in corporate taxation. Despite the differentials in terms of cost deductions and deduction limitations, stock valuation rules and (accelerated) depreciation mechanisms for tax base computation purposes, all basically subject the realized nominal return to equity to corporate tax. That is, also regardless of the presence of tax incentives subsequent to the apportioning process, such as tax credits to post-apportioned tax base. Essentially, these formulary systems all adopt a traditional corporate income tax base.

The consequence of using a traditional realization-based return to equity standard for corporate tax base computation purposes is a tax-favoring of debt financing over equity financing. The formulary systems currently in place in the US and Canada accordingly suffer the same financing discrimination defect as traditional corporate income tax systems in the international tax regime employing SA/ALS do. The same holds true for the proposed CCCTB. As discussed in Chapter 5, to eliminate the financing discrimination issues and to arrive at a tax base computation approach that would be neutral towards marginal investment decisions, only infra-marginal returns should be subject to the tax. For that reason, I advocated an approach of making use of an allowance for corporate equity ('ACE').[1620] This argument holds up equally under a formulary system as it does under SA/ALS. There is no

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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.

[1619] *Ibidem*, and Maarten F. de Wilde, *Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy*, 38 Intertax 281 (2010), and 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.

[1620] Cf. Howell H. Zee, 'Reforming the Corporate Income Tax: The Case for a Hybrid Cash-Flow Tax', 155 De Economist 417 (2007), at 417-448, and Serena Fatica et al, 'Taxation Papers; The Debt-Equity Tax Bias: Consequences And Solutions', *European Commission Directorate-General Taxation & Customs Union* 2012:33.

reason why an ACE could not be linked to a formulary system. Profit allocation methodologies should not be confused with tax base design issues. Again, that is for these constituting analytically separate matters.

6.4.3.5 The group as a taxable entity: also under FA

With respect to the tax unit definition under a formulary system, matters should be elaborated somewhat further. First, conceptually, taxing jurisdictions using formulary apportionment to divide corporate profit are not necessarily required to harmonize the tax unit, just as the use of SA/ALS does not. The CCCTB proposal, for instance, defines taxpayers as the eligible companies that opted to apply the system.[1621] Eligible are those companies that have been established under the laws of a Member State and are subject to the corporate tax of a Member State. With regards to third country company forms, the CCCTB refers to those companies that have specifically been listed in an annex to the CCCTB proposal.[1622] The CCCTB proposal does not in itself decide on the (non-)transparency for tax purposes of a particular legal entity, as it refers to the states involved for this purpose. These may have differing views on the matter.[1623]

To the extent that differential approaches are adopted at opposite sides of the tax-border(s), hybrid entity issues may leak into the system. This holds up to the extent that some taxing jurisdictions involved consider a particular corporate entity as tax-transparent, while others treat it as non-transparent. Issues may also arise, for instance, under the CCCTB proposal, to the extent that countries allow economic operators to elect for tax transparency treatment, like the US does under the 'check-the-box-rules' in its federal income tax system. Issues may, for instance, arise in regards to a US corporation operating a permanent establishment in a particular European Union Member State which classifies the corporation as an entity while it is being disregarded under the US entity classification rules (or vice versa).[1624]

Accordingly, as in international taxation, hybrid entity mismatches may also arise under the application of a formulary system. Worth noting is that the CCCTB proposal explicitly seeks to resolve potential hybrid entity mismatch issues under the application of the CCCTB system by assigning the entitlement to classify a legal entity as (non-)transparent to the Member State where the entity is 'located'.[1625] The approach taken under the CCCTB triggers various technical issues when the entity's place of effective management and place of incorporation differentiate. In such a case the entity's 'location' and its classification are indistinct as a result of this as well, causing the issue to be insufficiently resolved at the end of the day. This is not further discussed. [1626] Hybrid entity issues under formulary systems may alternatively be resolved by using a coordinated approach in defining the taxable entity.

Furthermore, second, it is not an analytical necessity to apply the formulary system to a tax-consolidated group or combined group of affiliated companies operating a single business

[1621] Article 4(1) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).
[1622] See Articles 2 and 3 Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). The companies established under the laws of a Member State need to take one of the forms listed in an annex to the CCCTB proposal and need to be subject to a corporate taxation listed in another annex to the CCCTB proposal. Regarding the third country corporate forms, the CCCTB proposal forwards that the Commission shall adopt annually a list of eligible companies.
[1623] Notably, the Presidency of the Council has suggested to introduce a deduction limitation at the taxpayer/payee level in cases where the payment involved is not included as a taxable item at the level of the taxpayer/recipient as a consequence of a hybrid entity mismatch; see the suggested Article 83a as found in the comments of the Presidency of the Council on the CCCTB proporsal (doc. 8387/12 FISC 49) published by the Council of the European Union, 16 April 2012, no. 2011/0058(CNS). This is not further discussed.
[1624] See for some further reading and analysis, David J. Rachofsky, 'Overview of the U.S. Tax Consequences of Disregarded Entities', 55 *Bulletin for International Taxation* 388 (2001), and Peter A. Glicklich et al, 'U.S. Taxation of E-Commerce under Subpart F – Missing Pieces Leave Uncertainty', 55 *Bulletin for International Taxation* 507 (2001).
[1625] Articles 84 and 85 Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).
[1626] See Matthijs Vogel, *Comment on the CCCTB Proposal,* Vakstudie H&I, Highlights and Insights on European taxation, 2011/6.1, at 61.

enterprise.[1627] Formulary apportionment and tax grouping are not inextricably linked. FA deals with the geographical attribution of tax base, it is not about tax unit definitions. This may be illustrated by reference to the Canadian formulary allocation system which applies on a per corporation basis to attribute corporate profits interprovincially to permanent establishments. Accordingly, the Canadian system makes use of a formulary approach only to interprovincially divide the profits of a single entity. The concept of tax grouping is alien to the Canadian tax system.[1628] Hence, Canada, operates a hybrid system: SA/ALS applies to allocate profit to corporations, regardless of whether they are part of a single economic entity. FA applies to distribute the profits of a single corporation among the provinces. Also a number of US states adopt FA to assign the profits of single corporations.[1629] In US state income taxation, this approach is referred to as 'separate company reporting'.[1630] Some US states allow firms to elect to apply formulary apportion on a separate entity basis (i.e., contrary to 'combined reporting', a US tax grouping concept that is touched upon hereunder).[1631]

Nevertheless, as argued in Chapter 4, in my view, the adoption of a common approach designating the group as a single taxable entity would promote equity and neutrality. That is, as the firm constitutes a single economic entity. The group concept has been defined in Chapter 4 by reference to a decisive influence criterion in conjunction with a business motive test requiring the corporate interest to be held as a capital asset.[1632] Such an approach would also cancel out hybrid entity mismatch issues. This holds equally true under the application of a formulary system. Accordingly, under the adoption of a formulary approach, I would favor using the 'unitary taxation approach' in this respect. In my view, as set forth in Chapter 4, the tax consolidation should apply mandatorily, as elective systems promote arbitrage.[1633]

As forwarded in Chapter 4, cancelling out the recognition of intra-group legal reality within the tax group for corporate tax purposes would entail a significant step in the direction of mitigating many of the current issues in international taxation. It would take away the key tools that are currently employed by countries and multinationals for engaging into artificial profit shifting through 'tax sheltering', i.e., the legal shifting of intangible resources available within the multinational to low or no-taxing jurisdictions.[1634] The cross-border relocation of the firm's

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[1627] Cf. Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 27: *"Neither consolidation nor (unitary) combination is required to implement a formulary apportionment system"*, and at 9: *"Formulary apportionment can be applied to distribute the income of a single entity, as in Canada, or to distribute the income of a related group of corporations, as in many US states."*

[1628] Between 1932 and 1951 the Canadian tax system allowed affiliate corporations to file a consolidated tax return. In 2010, the Canadian Department of Finance issued a consultation paper *'The taxation of corporate groups'* to assess the desirability of introducing a tax grouping regime in the Canadian tax system. However, matters have been put on a hold since the announcing in the 2013 Budget that the adoption of a tax grouping system is not a priority at this time. For some comments and background analysis, see Maureen Donnelly et al, 'Policy Forum: Group Relief for Canadian Corporate Taxpayers—At Last?', 59 *Canadian Tax Journal* 239 (2011), at 239-263.

[1629] For a list see Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at. 13. See also Michael McIntyre, 'The Use of Combined Reporting by Nation States', in Brian J. Arnold et al eds., *The Taxation of Business Profits Under Tax Treaties* (2003) 245, at 246.

[1630] See Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 204

[1631] *Ibidem*, and Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 75-76, and 187.

[1632] See also 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.

[1633] See for a comparison on the optional CCCTB system, Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 56: *"the Commission proposed making the consolidated base tax system with formulary apportionment optional. Although making the system optional may have many political advantages, it may also introduce some economic disadvantages"*. On the allowing of companies to elect the way they are being taxed, Weiner refers to Jack Mintz, 'European Company Tax Reform: Prospects for the Future', 3 *CESifo Forum* 3, (2002), at 3-9, who argues that this *"would substantially erode efficiency gains from harmonization since companies would have greater opportunities to engage in tax arbitrage domestically, not just with respect to cross-border transactions."*

[1634] As discussed, it typically involves the intra-group legal shifting towards these jurisdictions of the firm's financial resources or intellectual property. Commonly utilized tools in this respect are the setting-up and tax-establishing of controlled legal entities within such jurisdictions and the subsequent arranging of intra-group legal transactions to create tax-recognized income streams directed towards those jurisdictions. This is established quite easily because of the mobile characteristics of these intangible resources and the absence of third-party market realities in the controlled intra-firm environments within which these transactions generally take place. Textbook profit shifting

resources through controlled legal transactions would be rendered impossible.[1635] *"Full consolidation is the only way of overcoming the problems linked to transfer pricing for intra-group transactions."*[1636]

Indeed, the CCCTB system envisages the formula to apply to the tax consolidated CCCTB group where the parent company is designated as the 'principal taxpayer'.[1637] Furthermore, various US states apply their apportionment formulae to divide the combined profits of a group of affiliated corporations that operate a 'unitary business'. This is a US state income tax practice of taxable profit pooling that is referred to as 'unitary combination' or 'combined reporting'.[1638] The concept of combined reporting is a conceptual cousin of tax consolidation. Both entail the pooling of profits and the elimination of intra-group legal transactions for corporate tax purposes. [1639] Notably, making use of the concepts of unitary combination ('UC') and formulary apportionment ('FA') in conjunction is generally referred to as 'unitary taxation' ('UT').[1640]

Worth noting to substantiate things further are the tax planning opportunities relating to the non-tax grouping properties of the Canadian tax system and the US state income tax systems adopting 'separate company reporting'. Economic analyses in these areas reveal that, indeed, such systems are exposed to base erosion and profit shifting opportunities.[1641] It has been found that the Canadian formulary allocation system is vulnerable to interprovincial profit shifting. Research on the Canadian system suggests that if corporate groups do not tax-consolidate *"a number of tax planning devices are essentially unrestricted for firms that*

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arrangements involve intra-group debt financing and licensing arrangements. These generate tax-deductible interest and royalty payments in the countries where real investment takes place. Such tax planning tools have been readily made available under the tax systems of countries for MNEs to be utilized to arbitrarily shift real profit to low or no-taxing jurisdictions.

[1635] Cf. Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

[1636] See for a comparison, Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9 referring to the merits of adopting unitary taxation within the European Union. At 8: *"an EU CTB would address many of the tax obstacles imposed by the SA methodology and could contribute to improving the functioning of the Internal Market. In particular, the C+A* [consolidation and apportionment, MdW] *method referred to above would: (i) reduce compliance costs for companies, as they would not have to deal with many (up to 25) different national tax systems; (ii) allow, in general, full and automatic cross-border offsetting of losses across all group's members (ie, either with vertical or horizontal relationships); (iii) simplify costly intra-EU intra-group transfer pricing obligations, as intragroup transactions are eliminated out when calculating the CTB and therefore, in principle, there would be no need to price them at arm's length any longer; (iv) eliminate the profit shifting incentives that SA currently provides for MNEs and in consequence limit governments' incentives to compete for "shifty profits", which may result in inefficiently low corporate income tax rates; (v) reduce the risk of international juridical double taxation arising from the non-coordination between some international tax rules."*

[1637] See Chapter IX in conjunction with Chapter XVI Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).

[1638] The US Supreme Court considers the 'unitary business principle', i.e., the notion of recognizing the firm to constitute a single unit for corporate tax purposes regardless of its legal organization, *"the linchpin of apportionability in the field of state income taxation"*. See United States Supreme Court, *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S. Ct. 1223 (1980), at 439. For some historical background and analysis, see Jerome R. Hellerstein, 'State Taxation Under the Commerce Clause: the History Revisited', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 53, at 53-81. Michael McIntyre, 'The Use of Combined Reporting by Nation States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits Under Tax Treaties* (2003) 245, describes the US concept of 'combined reporting' at 256.

[1639] The differences to a great extent are of an administrative nature. *"The combined report differs from a consolidated return in a number of aspects. Perhaps most importantly, a consolidated return treats and taxes a number of related entities as a single taxpayer, whereas the combined report is used to determine the proper amount of income reportable by each entity engaged in a single unitary business and includable in its individual return. In other words, a consolidated return involves a single return while the combined report is not a return at all and does not relieve any entity from its duty to file a return,"* Benjamin F. Miller, 'Worldwide Unitary Combination: The California Practice', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination*(1984) 132, at 136. Notably, David R. Milton, 'Comments on Miller', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 182, at 190 argues that *"there is no visible difference between this combination and a consolidation."*

[1640] See Sijbren Cnossen, 'Taxing capital income in the European Union: Summary and discussion', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 1, at 10.

[1641] See Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 252-253.

incorporate separately in separate provinces".[1642] That is, this is accomplished by means of a strategic setting of intra-group transfer pricing strategies, particularly through intra-group debt financing. It has also been found that companies that apportion income to permanent establishments under the formulary allocation system are less sensitive to changes in the provincial tax rates than comparable groups of companies that assign corporate profit to affiliates on a separate entity basis.[1643] The lack of tax consolidation has therefore been argued to be the main shortcoming of the Canadian system.[1644] Similar results have been found by the Multistate Tax Commission studying the US state income tax system on this aspect. The Multistate Tax Commission found that 'combined reporting states' are less vulnerable to tax sheltering than 'separate entity states'.[1645]

However, such an interprovincial (Canada) or interstate (US) shifting of corporate tax base through strategic transfer pricing may be considered not too problematic, or in any case, manageable,[1646] at least relative to the international profit shifting opportunities under SA/ALS. The subnational tax rate differentials within Canada and the US are, in terms of magnitudes and revenue volumes, less sizeable in comparison to their international counterparts. Furthermore, matters are mitigated in both Canada and the US, as federal taxes apply supplemental to the sub-national taxes. These federal taxes secure a minimum level of corporate taxation. And contrary to its international equivalents, the tax planning in these cases occurs within a single federal state. Finally, in Canada, matters are further mitigated as a result of the equalization programs.[1647]

Given the sizeable differentials in the European Union Member States' corporation tax rates, the inclusion of a tax-grouping concept in the CCCTB proposal in conjunction with the formulary sharing mechanism has nevertheless been argued to constitute the only valid alternative worthy of consideration.[1648] Worth quoting at this point are the words of Miller on the use of unitary taxation in US state income taxation: *"Authorizing formula apportionment without providing for combined reporting is similar to supplying an armored force with tanks that cannot move."*[1649] As Pomp puts it: *"A state that does not require related corporations conducting a unitary business to file a combined report is at the mercy of its corporate taxpayers."*[1650] I can only concur with that.

6.4.3.6 Favoring worldwide unitary combination over water's edge limitation

Conceptually, the application of a formulary system is not necessarily confined to a restricted geographic area. That is, although the scope of the US, Canadian and CCCTB formulary systems' applications are basically all geographically limited to the 'water's edge', i.e., the respective country's (US, Canada) or supranational organization's (European Union) territories. As a rule, all US states treat foreign entities that operate outside US territories – e.g., foreign parent companies, foreign subsidiary companies, and foreign sister companies – as distinct entities for state income tax purposes.[1651] That is the case even if these companies

[1642] See Jack Mintz et al, 'Income shifting, investment, and tax competition: Theory and evidence from provincial taxation in Canada', 88 *Journal of Public Economics* 1149 (2004), at 1149-1168.
[1643] *Ibidem*.
[1644] See Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 4.
[1645] See Multistate Tax Commission, *Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections*, July 15, 2003.
[1646] See Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 176, and for a comparison also Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 6 (par. 14).
[1647] See also Jack M. Mintz, 'Corporate Tax Harmonization in Europe: It's All About Compliance', 11 *International Tax and Public Finance* 221 (2004), at 221-234.
[1648] Cf. Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 252.
[1649] Benjamin F. Miller, 'Worldwide Unitary Combination: The California Practice', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 132, at 132.
[1650] Richard D. Pomp, 'The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer', 16 *State Tax Notes* 939 (22 March 1999), 939-948, at 945.
[1651] The exception is Alaska which requires firms that are engaged in oil and gas activities in Alaska to use worldwide unitary combination.

constitute a functionally integrated part of a group of companies which is being subject to taxation in the US.[1652] Under its formulary allocation system, Canada basically does the same.[1653] And so does the CCCTB proposal. The proposed CCCTB system does not operate across the outer geographical borders of the European Union's territories, excluding the income and operations of third-country affiliates from the formulary apportionment system. All apply separate accounting at the water's edge. Only US, Canadian and European Union source incomes, as attributed to these countries' territories by reference to SA/ALS, are subject to the apportionment formulae. With regards to the attribution of returns on outbound investment and inbound investment across the water's edge, these jurisdictions basically operate a traditional transfer pricing system, accordingly.

It needs to be noted that until the mid-1990s, various US states, of which the most notable is California, applied their unitary taxation systems mandatorily on a worldwide basis.[1654] This approach has been referred to as 'worldwide unitary combination' or 'worldwide unitary taxation'.[1655] To compute the part of the firm's profit that is subject to taxation in the taxing state involved, this approach basically pools together the worldwide profit of the multinational firm and cancels out all inter-affiliate transactions worldwide. That is, the firm's foreign profits derived through both domestic and foreign entities having no in-state nexus are included in the combined report. Subsequently, the apportionment formula is applied to the unitary combination's worldwide earnings, taking into account both foreign and domestic inputs and outputs. Worldwide unitary combination accordingly assigns the firm's worldwide profits geographically on a formulary basis by reference to the firm's inputs and outputs. That is, regardless of the firm's legal organization and regardless of whether the apportioning process attributes profit to locations outside or inside the respective taxing jurisdiction. Worth noting is that the US Supreme Court constitutionally sanctioned the accounting for unitary taxation purposes of both the firms' profits derived through foreign subsidiary companies and foreign parent companies.[1656]

However, the US states, acting independently, abandoned mandatory worldwide unitary combination in the mid-1990s. This occurred under the threat of federal legislation in response to political pressures of US trading partners, and the lobbying work of multinationals seeking ways to reduce their tax burdens.[1657] Indeed, the practicing of worldwide unitary

[1652] It should be noted that states regularly apply extensive water's edge definitions to enable themselves to include the entire income and apportionment factors of foreign (i.e., non-US) companies into the combined report for state tax calculation purposes. This, e.g., by referring to so-called '80/20 corporations'. '80/20 corporations' are typically defined as corporations, regardless of the place incorporated or formed, that are members of a unitary group and whose property, payroll, and sales factors within the US is 20 percent or more. Qualifying foreign companies are fully accountable to state income tax under such rule. See for a comparison Sec 5(A)(ii) Multistate Tax Commission Proposed Model Statute for Combined Reporting, As approved by the Multistate Tax Commission August 17, 2006, As amended by the Multistate Tax Commission July 29, 2011.

[1653] Please note that the Canadian system applies the formulary allocation mechanism to non-Canadian permanent establishments of Canadian resident companies. The income of Canadian companies that is allocable to foreign jurisdictions is not effectively subject to provincial or territorial taxes. The Canadian provincial and territorial taxes fall outside the scope of application of the Canadian double tax conventions. With regards to the foreign PEs of Canadian corporations, Canada accordingly adopts some kind of a worldwide approach rather than a strict water's edge limitation. Mayer explains that it may therefore be somewhat misleading to describe the Canadian system as a 'water's edge' system. See Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 115.

[1654] For an overview of US states that applied unitary combination on a worldwide basis, see Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 256-257.

[1655] For extensive analyses, see Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984).

[1656] The US Supreme Court constitutionally sanctioned worldwide unitary combination in *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983). Worldwide unitary combination for US corporations having non-US affiliates (both non-US subsidiaries and non-US parents) has been sanctioned by the US Supreme Court in *Barclays Bank PLC v. Franchise Tax Board of California*, 512 U.S. 298 (1994).

[1657] See e.g. Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 254-258, and Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at par. 4.3.

taxation by these US states succumbed following fierce protests, controversy, heated debates, and even the threats from abroad of the introduction of retaliatory legislation.[1658]

The practice of abandoning worldwide unitary combination has been explained in the literature as a political expedient.[1659] The principal reason for the system's abolishment was its difference from the obtained international consensus of dividing multinational profits by employing SA/ALS. It differed and, therefore, it was considered bad. Particularly the assignment of profit to the location of firm outputs under supply-demand based formula factors renders FA to produce outcomes not corresponding with the supply-based profit attribution under SA/ALS – and vice versa of course. Dependent on facts and circumstances, the different approaches taken may produce double (non-)taxation. The key differential of FA adopting a supply-demand and SA/ALS using a supply approach may essentially explain many of the controversies in this area.[1660]

Regardless, a range of US states, up until today, enable companies to apply worldwide unitary combination on an elective basis. California for instance allows firms to elect to file the tax return on a worldwide combined basis or by reference to water's edge combination.[1661] Interestingly, *"in 1993, the California legislature had proposed making water's edge combined reporting mandatory, but eventually made water's edge reporting optional in response to business interest in preserving the ability to file on a worldwide combined basis."*[1662] Notably, the exception is Alaska which currently requires oil and gas firms to apply mandatory worldwide combination.

Various commentators argue, validly in my view, that in today's global marketplace, a worldwide unitary business approach would conceptually be the most appropriate – see also Chapter 4 where the same approach has been advocated.[1663] The argument, first, is that the S-H-S concept of income, particularly the underlying ability to pay principle, essentially requires that the multinationals global profits are taken into consideration for corporate tax calculation purposes. Notably, the inclusion of foreign income in the taxable base does not mean that tax sovereignty is extended to foreign income as double tax relief is provided for those income items.[1664] Moreover, second, the theory of the firm essentially requires that the multinational group should be considered to constitute a single taxable entity for corporate tax

[1658] For an overview of positions at the height of the debates surrounding worldwide unitary combination, see George N. Carlson et al, 'Water's Edge Versus Worldwide Unitary Combination', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 1, at 1-40.
[1659] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 292.
[1660] Cf. Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 240: *"Although a factor-location formula may be designed to approximate the results of separate accounting, a formula that includes both the location of factors of production and of sales destination will not. There is a fundamental dichotomy between the two. Indeed, much of the tension in argument between those who advocate formula apportionment and those who in principle prefer separate accounting is attributable to the inclusion of the sales factor in the formula."*
[1661] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 292.
[1662] See Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 36.
[1663] See e.g., Lorence L. Bravenec, 'Corporate income tax coordination in the 21st century', 40 *European Taxation* 450 (2000), at 460, COM(2003) 726 at 23, Benjamin F. Miller, 'None Are So Blind as Those Who Will Not See', 66 *Tax Notes* 1023 (13 February 1995), at 1023-1035, Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises', 62 *Bulletin for International Taxation* 201 (2008), at 201-215, Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, 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), Kerrie Sadiq, 'Unitary taxation – The Case for Global Formulary Apportionment', 55 *Bulletin for international taxation* 275 (2001), at 275-286. See also Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, as well as 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.
[1664] Cf. Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 228, at 235.

purposes, in line with economic realities.[1665] *"The income of a common enterprise should be taxed without regard to its organizational structure. Substance should prevail over form. Form is elevated over substance when the income from the foreign activities of a common enterprise is excluded from the combined report if those activities are conducted through a foreign corporation but the income is included in the combined report if the activities are conducted through a foreign branch of a domestic company. Obviously, the operation of a common enterprise engaged in cross-border activities is not confined by the borders of a single country."*[1666] From this perspective the application of the unitary business approach on a worldwide basis is 'but a logical corollary of the growing complexity of contemporary business reality'.[1667] Cross-border tax grouping is even considered essential given the arbitrage produced by multinational profit division under separate accounting.

As a practically feasible alternative to worldwide unitary combination, various scholars have advocated introducing a cross-border tax grouping approach at regional levels, for instance within North America,[1668] South America, the Asian-Pacific Region,[1669] Africa,[1670] and the European Union – within which the initiative for this has already been launched by means of the CCCTB proposal.[1671] The existing free trade organizations may perhaps provide the stepping stones for building a legal framework in this respect. Accordingly, the water's edge limitation would be set at the outer geographical borders of the territories of these regions. The application of a cross-border tax grouping approach on regional bases may perhaps indeed be pragmatically and politically more feasible than its global alternative. That would particularly hold true if the multilateral coordination at this point would include the world's larger producing regions.

However, the introduction of water's edge limitations at regional levels would have the consequence of an inability to deal sufficiently with multinational firms that are operational across these regional tax-borders. As SA/ALS would apply at the water's edge, such a regionalization of the unitary business approach would analytically re-introduce the profit allocation issues accompanying its use in the same manner as elaborated upon extensively in the above. As McIntyre notes: *"Allowing some members of a combined group to exclude themselves from the combined report under a water's-edge rule obviously opens up opportunities for tax avoidance. The principal danger, from the perspective of a nation-state,*

[1665] Cf. 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, and Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013), at 40-55.
[1666] Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 292.
[1667] Paraphrasing George N. Carlson et al, 'Water's Edge Versus Worldwide Unitary Combination', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 1, at 6.
[1668] See Paul R. McDaniel, 'Formulary Taxation in the North American Free Trade Zone', 49 Tax Law Review 691 (1993-1994), at 691-744. See Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation', 50 *Canadian Tax Journal* 823 (2002), at 843, who refers to McDaniel also. See further Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, who mentions the alternative of employing formulary approaches at regional levels as well (NAFTA, EU), i.e., at 246 and 293-293, and Robert S. McIntyre et al, 'Using NAFTA to Introduce Formulary Apportionment', 6 *Tax Notes International* 851 (5 April 1993), at 851-856.
[1669] See Richard J. Vann, 'A Model Tax Treaty for the Asian-Pacific Region? (Part I)', 45 *Bulletin for International Fiscal Documentation* 99 (1991), at 99-111, and Richard J. Vann, 'A Model Tax Treaty for the Asian-Pacific Region? (Part II)', 45 *Bulletin for International Fiscal Documentation* 151 (1991), at 151-163.
[1670] See Oliver Oldman et al, 'The Unitary Method and the Less Developed Countries: Preliminary Thoughts', 1987 *Int'l Bus. L.J.* 45 (1987), at 45-61.
[1671] The European Commission established its policy for developing the CCCTB in its 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*, COM(2001) 582 final, 23 October 2001. It confirmed it in its Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, *An Internal Market without company tax obstacles achievements, ongoing initiatives and remaining challenges*, COM(2003)726 final, 24 November 2003. Matters in this area were already being discussed prior to the Commission establishing its policy objectives. See Charles E. McLure, Jr., 'Economic Integration and European Taxation of Corporate Income at Source: Some Lessons from the U.S. Experience', 29 *European Taxation* 243 (1989), at 250, Mike McIntyre, 'Harmonizing Direct Taxes in the EEC', 2 *Tax Notes International* 131 (1990), at 131-132, Alicia Munnell, 'Taxation of Capital Income in a Global Economy: An Overview', *New England Economic Review* 33 (1992), at 33-51, and Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 243-292.

is that the entities included in the combined group will deflect income derived by members of the group to entities engaged in the common enterprise that have been excluded from the combined group by the water's-edge rule"[1672] Various commentators, for instance, have addressed the CCCTB's vulnerability of being subject to base erosion and profit shifting across the water's edge.[1673]

The emergence of these issues under water's edge limitations explains the presence of the halfway-house anti-abuse measures in formulary systems, common in international taxation. To cope with base erosion and profit shifting issues relating to water's edge limitations, the CCCTB proposal, for instance, contains interest deduction limitations and a controlled foreign company regime.[1674] In the field of US state income taxation, the Multistate Tax Commission in its proposed 'Model Statute for Combined Reporting' suggests including controlled foreign companies in the combined report. This would be done to counter the tax-sheltering of profits in low-taxing jurisdictions.[1675] However, at the end of the day, such anti-abuse rules are merely fighting the symptoms of an ill approach. The issues involving the taxation of globally integrated multinational firms may only be truly overcome by means of the adoption of a coordinated worldwide tax-grouping concept, accordingly canceling out all intra-firm legal realities for corporate tax purposes – and with that the profit shifting and base erosion opportunities that they bring.

The remaining part of this chapter takes the approach of adopting worldwide tax-consolidation or worldwide unitary combination to solve the problem of the water's edge limitations producing analytically sub-optimal outcomes. As advocated in Chapter 4, the approach is taken whereby the firm is treated as a single taxable entity, since the multinational firm economically is a single entity.[1676] Now let us return to the topic of profit attribution under FA.

6.4.4 FA does not put to an end real profit shifting but could end paper profit shifting if well-designed

6.4.4.1 FA seeks to approximate location of income by locating income generating activities

FA mechanisms, as said, generally seek to fairly divide corporate profit among tax jurisdictions by using a predetermined fixed formula. For this purpose, the traditional regimes apportion corporate earnings by reference to both the locations of firm inputs and firm outputs. The approaches taken in the US, Canadian and CCCTB systems basically all boil down to the same methodology.

A typical apportionment formula takes the following form:[1677]

[1672] See Michael McIntyre, 'The Use of Combined Reporting by Nation States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits Under Tax Treaties* (2003) 245, at 293.

[1673] Cf. Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 258, and Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38, Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 223 and 234 (footnote 72) refers to this as the system's 'Achilles heel'.

[1674] Articles 80-81 and 82 CCCTB Proposal, as well as Article 14a (the latter mentioned as an alternative for Article 81 as suggested by the Presidency of the Council; the provision can be found in the comments of the Presidency of the Council on the CCCTB proporsal (doc. 8387/12 FISC 49) published by the Council of the European Union, 16 April 2012, no. 2011/0058(CNS). This is not further discussed.

[1675] Sec. 5(A)(v) Multistate Tax Commission Proposed Model Statute for Combined Reporting, As approved by the Multistate Tax Commission August 17, 2006, As amended by the Multistate Tax Commission July 29, 2011. Various US states adopt similar anti-abuse rules as well. See on this matter, e.g., Michael J. McIntyre et al, 'Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana', 61 *Louisiana Law Review* 699 (2001), at 699-761, reprinted in 21 *State Tax Notes* 741 (2001), at 741-769.

[1676] See for a comparison OECD, *Addressing Base Erosion and Profit Shifting, OECD Publishing, 12 February 2013, at 25, where the OECD refers to the multinational firm as a single economic entity.*

[1677] The formula has been taken from Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 94. For an alternative, see the formula in Article 86 Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS), discussed in Maarten F. de Wilde, 'Tax

$$_i = PT_T \times \left(a_i \frac{A_i}{A_T} + l_i \frac{L_i}{L_T} + r_i \frac{R_i}{R_T} \right) \; with \; a_i + l_i + r_i = 1$$

- P_i expresses the profit that is apportioned to state I, whereby the taxable base may be defined as the realized nominal return to equity, EBIT, or the economic rent (of which I favor the latter, see Chapter 5);
- P_T reflects the total profits of the taxable entity, whereby the taxable entity may be defined as the single entity or the combined group, or tax consolidated group (of which I favor the latter, see Chapter 4);
- a_i expresses the weight that is attributed to the firm input factor of 'assets' at origin (i.e., debits, property or assets);
- l_i denotes the weight that is attributed to the firm input factor of 'labor' at origin (i.e., payroll or salaries);
- r_i expresses the weight that is attributed to the firm output factor of 'revenue' at destination (i.e., sales or gross receipts);
- A_i/A_T, L_i/LT, and Ri/R_T respectively represent the portions of assets, labor and revenues located in state I relative to total assets, labor and revenue of the taxable entity.

The application of such a mathematical profit attribution mechanism has the following effect. Corporate profit is apportioned to taxing jurisdictions uniformly and in proportion to the apportionment factors that are used in the formula. Profit is divided directly proportional to the factors that are located in the respective taxing jurisdictions. Under unitary taxation, moreover, profit is attributed uniformly among the controlled entities making up the enterprise involved. All legal entities are effectively attributed constant shares of the firm's profitability for tax computation purposes.

This, however, does not mean that formulary mechanisms are built on the implicit assumption that corporate profit, in reality, is generated uniformly by the operational group entities involved and geographically in proportion to the formula factors used.[1678] That is, although that outcome of the apportionment formula under unitary taxation is the anticipated one.

Formulary systems, as said, do not seek to locate *the* source of income. Merely, as explained in the above, formulary systems modestly seek to establish a fairly reasonable proxy to share corporate profit among jurisdictions by reference to the performance of income generating activities within the taxing jurisdictions' territories. It should be kept in mind that corporate income lacks geographic attributes. Corporate income has no geographic location.[1679] Empirical research undertaken suggests that although quintessential for income generation, neither firm inputs nor firm outputs *explain* profit or its location; as rents are increasingly firm specific, no correlations seem to exist between (the location of) inputs, (the location of) outputs and (the location of) profit.[1680] As a result, as previously stated, *any* profit attribution method, both the smoke and mirrors of SA/ALS as well as the predetermined formulae of FA, merely seem to provide for a proxy and are arbitrary as a consequence.[1681] And if it would be feasible to identify *the* true source of income, one would not need proxies.

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competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

[1678] Cf. Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 253 and Jerome R. Hellerstein, 'Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment', 60 *Tax Notes* 1131 (23 August 1993), at 1140.

[1679] Cf. Walter Hellerstein, 'International Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment', 12 *International Transfer Pricing Journal* 103 (2005), at 104, and Peggy B. Musgrave, 'Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union, Issues and Options for Reform* (2000) 46, at 46-77.

[1680] See for a comparison James R. Hines Jr., 'Income misattribution under formula apportionment', 54 *European Economic Review* 108 (2010, No. 1), at 108-120.

[1681] Cf. Richard M. Bird et al, 'Source vs. residence-based taxation in the European Union: the wrong question?', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 78, at 91.

The geographic profit attribution under formulary apportionment, indeed to some extent, is also arbitrary. It would surely be a coincidence if firm profitability across the countries would vary proportionally to the factors that are represented in the formula. Notably, the effect produced under a formulary approach is precisely one of the key reasons for the OECD to categorically reject the application of predetermined formulae to attribute business profits to taxing jurisdictions.[1682] But, as said, the origin-oriented SA/ALS standard does not capture the income's true source either. Tax havens would not exist if it did. That is, at least to the extent that one agrees that multinationals do not earn substantial parts of their income in these jurisdictions.

So why consider formulary apportionment? It should be noted that although formulary systems do not seek to identify the true geographical whereabouts of income, typical apportionment formulae are not built on randomly chosen factors. On the contrary, the factors chosen represent actual income generating activities undertaken within a firm, inputs and outputs representing the supply-side and demand-side of income production. As a consequence, if well-designed, formulary mechanisms do not incentivize paper profit shifting across countries to reduce effective tax burdens.[1683]

Notably, in the US, the constitution requires the US states to adopt formula factors that *"reflect a reasonable sense of how income is generated"*, i.e., the 'external consistency test'.[1684] The apportionment formula should reasonably represent the taxpayer's economic activities within the taxing jurisdiction involved. US constitutional law further requires the states to adopt a formula that is *"such that, if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed"*, i.e., the 'internal consistency test'.[1685] A challenged tax measure passes this test if the following question answers in the affirmative: *"if all 50 states enacted the challenged rule, would interstate commerce bear a burden that purely domestic commerce would not also bear?"*[1686] Accordingly, *"a state tax must be structured so that if every state were to impose an identical tax, interstate commerce would fare no worse than intrastate commerce."*[1687] Kindly note that the approach taken under

[1682] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Chapter I at par. 1.25: *"One such concern is that predetermined formulae are arbitrary and disregard market conditions, the particular circumstances of the individual enterprises, and management's own allocation of resources, thus producing an allocation of profits that may bear no sound relationship to the specific facts surrounding the transaction. More specifically, a formula based on a combination of cost, assets, payroll, and sales implicitly imputes a fixed rate of profit per currency unit (e.g. dollar, euro, yen) of each component to every member of the group and in every tax jurisdiction, regardless of differences in functions, assets, risks, and efficiencies and among members of the MNE group. Such an approach could potentially assign profits to an entity that would incur losses if it were an independent enterprise."* See for a comparison Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 258. Furthermore, see Yariv Brauner, 'BEPS: An Interim Evaluation', 6 *World Tax Journal* 10 (2014), at 31: *"… the most important additional element required – the addition of formulary elements. Although important, it is the elephant in the room that has unfortunately fallen into the OECD's … "blind spot". The addition of formulary elements, some of which the OECD has been considering anyway, and dressing it with thinly veiled arm's length rhetoric, is essential and particularly appropriate to the BEPS project."* And: *"The language of Action 8* [i.e., the OECD's action item to assure that transfer pricing outcomes are in line with value creation, MdW] *feeds further concern. Of course, it begins with the dictation that arm's length is the consensus and cannot be breached, even if it fails. Regardless of the rhetoric, it is past time for the OECD to relax the escalation of this distinction between arm's length and formulary taxation. The language of the Action Plan may lead one to falsely believe that arm's length taxation is the end, not the means, to ward appropriate and stable allocation of tax bases among countries."*

[1683] See e.g. Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 9 (par. 21).

[1684] See e.g., United States Supreme Court, *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983).

[1685] *Ibidem*, and, e.g., United States Supreme Court, *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995).

[1686] See Ruth Mason, 'Made in America for European Tax: The Internal Consistency Test', 49 *Boston College Law Review* 1277 (2008), at 1283. See also Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 252-254.

[1687] See Walter Hellerstein, 'Is "Internal Consistency" Dead?: Reflections on an Evolving Commerce Clause Restraint on State Taxation', *University of Georgia School of law Research Paper Series*, Paper No. 07-005, February 2007, at 1.This working paper has been published in Tax Law Review; Walter Hellerstein, 'Is "Internal Consistency" Dead?: Reflections on an Evolving Commerce Clause Restraint on State Taxation', 61 *Tax Law Review* 1 (2007-2008). See

the 'internal consistency test' in US constitutional law is identical to that taken in Chapter 3 demonstrating the 'internal consistency' of the subjection of taxpayers having a taxable presence within a taxing state to unlimited taxation whereby double tax relief is granted by reference to the Dutch-style 'tax exemption' method.[1688] In that chapter at section 3.2.3 reference is made to the approach taken, which is referred to as a 'thought-experiment'.

There is nothing artificial about the factors used in a typical apportionment formula, i.e., if well-designed. The payroll factor reflects a firm resource: the production factor of labor. The asset factor reflects a firm resource as well: the debits used by the firm in its business process as financed with equity or debt capital. The asset factor accordingly represents the production factor of capital, i.e., at least indirectly. The sales factor reflects the firm's business outputs that constitute an essential component in the generation of income also. By assigning inputs and outputs to the jurisdictions of origin and destination, formulary systems accordingly seek to assign profit to the production states (supply-side) and marketing states (demand-side).

The arbitrary elements in apportionment formulae are not the factors themselves, but the proxies that are applied in locating, weighing and evaluating them. And, as we have seen, the use of judgments and proxies in these areas are a necessity as income has no true location.

6.4.4.2 The formula factors and their effects further assessed

6.4.4.2.1 Nexus and allocation, also required in FA

Like any profit division mechanism, formulary systems also require the establishing of a taxable presence concept to geographically capture a firm's economic presence within a jurisdiction ('nexus'), and a methodology to subsequently evaluate the income that the respective firm is considered to derive at that particular geographic location ('allocation').[1689]

With regards to the assignment of firm inputs, the aim is to localize the firm's workers and assets at their origin, i.e., the location where the workers exercise their employment contracts and where the assets are functionally utilized in the business process ('nexus'). The inputs are subsequently evaluated essentially by reference to the remunerations that the firm pays in return for utilizing its workers and assets in the business process ('allocation'). Accordingly, the inputs are typically evaluated at cost, i.e., labor costs and the costs of the property used. Formulary mechanisms essentially utilize a cost-based evaluation technique in this respect. Expected future profit is disregarded.

As regards the assignment of firm outputs, the aim is, or at least should be, to localize the firm's customers at destination, i.e., where these customers utilize or consume the services and goods that were provided to them ('nexus'). The outputs are subsequently evaluated essentially by reference to the remunerations that the firm receives in return for the goods and services that it provides ('allocation'). Accordingly, the outputs are typically evaluated by reference to the firm's gross receipts from third-party supplies of goods and services. Formulary mechanisms essentially utilize a revenue-based connecting factor. Cost-

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also the prequel to this article, Walter Hellerstein, 'Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation', 87 *Michigan Law Review* 139 (1988-1989).

[1688] The approach has been taken identically in Maarten F. de Wilde, 'Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy', 38 *Intertax* 281 (2010), 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, 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, Maarten F. de Wilde et al, 'The New Dutch 'Base Exemption Regime' and the Spirit of the Internal Market', 22 *EC Tax Review* 44 (2013).

[1689] Cf. Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

deductions are not taken into account. The same holds true for financial outflows that cannot be regarded to constitute a revenue, e.g. loan repayments.[1690]

6.4.4.2.2 A plea for coordinating nexus and allocation standards in line with inputs and outputs through 'factor presence tests'

Formulary systems typically create disconnect between nexus and allocation rules

Peculiarly, the Canadian formulary allocation system, the CCCTB's sharing mechanism, as well as, traditionally, the apportionment systems in the US states, have created a disconnect between the nexus concepts used to establish a firm's taxable presence within a taxing jurisdiction and the allocation approaches adopted to geographically divide the taxpayer's taxable corporate profit. The standards used for these purposes typically differentiate.

To establish a firm's taxable presence (nexus), interestingly, it has traditionally been quite uncommon to refer to the utilized formula factors (payroll, assets, sales), for instance, by reference to quantitative 'factor presence tests'. Under a factor presence nexus test, a firm's taxable presence within a state arises by reference to the amounts of payroll, property and/or sales that a business enterprise has within that state, subject to a quantitative *de minimis* threshold (wages paid, assets values, turnover).[1691] Such an approach would accordingly align nexus and allocation in a manner corresponding with firm inputs and outputs.

Instead, the lawmakers involved have traditionally set origin-based qualitative threshold standards for this purpose, referring to legal and physical-geographical connecting factors. Typical examples are the presence of a permanent establishment (Canada,[1692] CCCTB[1693]), the principal place of the corporation's business conduct (Canada),[1694] and the location of the respective company's registered office, its place of effective management or its place of incorporation (CCCTB).[1695] Notably, in the US, the states are autonomous in designing their nexus standards, save for constitutional[1696] and federal legislative restraints.[1697] The US

[1690] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 285.

[1691] See e.g. Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 202-205, Walter Hellerstein, 'State Taxation of Electronic Commerce', 52 *Tax Law Review* 425 (1996-1997), and Charles E. McLure, 'Implementing State Corporate Income Taxes in the Digital Age', 53 *National Tax Journal* 1287 (2000). See also Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 15 (par. 61), Multistate Tax Commission Policy Statement 02-02, *Ensuring the Equity, Integrity and Viability of State Income Tax Systems*, Amended October 17, 2002, and Multistate Tax Commission, *Federalism at Risk, A Report of the Multistate Tax Commission*, June 2003, at Appendix D. See also Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 56, *Report and overview of the main issues that emerged during the discussion on the sharing mechanism SG6 second meeting – 11 June 2007*, Taxud E1 OP, CCCTB\WP\056\doc\en, Brussels, 20 August 2007, at 10-11 (par. 38-40) and Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 15 (par. 61).
For some comparison, see Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), and Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006), at 266-279.

[1692] See Sec. 400(2) and 402(1), (2), and (3) Canadian Income Tax Regulations.

[1693] Article 86(1), Articles 4-6 and 54-55 in conjunction with Chapter XVI Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). See e.g. Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 15 (par. 61). The Commission Services *"suggest that, at least for the time being, for the apportionment of the tax base a physical presence in the MS should be necessary…."*.

[1694] Sec. 400(2) Canadian Income Tax Regulations.

[1695] *Ibidem*.

[1696] The Due Process Clause *"requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax"*. United States Supreme Court, *Miller Brothers Co. v. Maryland*, 347 U.S. 340 (1954). The (Dormant) Commerce Clause requires the meeting of a 'four-prong' test for a state to subject an out-of-state firm to tax: (1) sufficient nexus should exist between the taxing state and the taxpayer, (2) the state tax may not discriminate against interstate commerce, (3) the tax needs to be fairly apportioned, and (4) the tax should fairly relate to the services provided by the taxing state. See United States Supreme Court, *Complete Auto Transit, Inc. v. Brady, Chairman, Mississippi Tax Commission*, 430 U.S. 274 (1977). For in-depth analyses, see Jerome R. Hellerstein, 'State Taxation Under the Commerce Clause: the History Revisited', in Charles E. McLure, Jr. (ed.), *The*

states do not use the concept of permanent establishment to establish tax jurisdiction but that of *"doing business in …"*.[1698] The traditional standard used in US state taxation is 'physical presence'.[1699] Physical presence includes the carrying on of a trade or business (US), the presence of owned or leased tangible property, the presence of a workforce, agents or representatives[1700] or the firm's legal or commercial domicile (US).[1701]

Indeed, these nexus concepts to a great extent echo those utilized in international taxation. The concepts for basing nexus for US state tax purposes on the 'carrying on of a trade or business' and 'legal or commercial domicile' are analogues to the US federal tax concepts for basing nexus on the presence of a trade or business or permanent establishment, and the place of incorporation.[1702] And these US federal tax concepts broadly correspond to their equivalents in international taxation.

US state income taxation holds some notable exceptions, however. First, the presence of a workforce constitutes nexus in US state taxation. In international taxation, the mere presence of a workforce, as said, is generally insufficient to establish a taxable presence for corporate tax purposes.[1703] That is, perhaps save for the 'services PE' laid down in the United Nations Model Double Taxation Convention between Developed and Developing Countries.[1704] The operation of this nexus concept establishes tax jurisdiction regarding *"[t]he furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned."* The 'services PE' concept is absent in the OECD Model Tax Convention and the double tax convention networks of countries operating the OECD's permanent establishment concept.

A second notable exception from the approaches taken in international taxation is the establishment of 'economic nexus' in US state taxation by reference to a firm's 'economic

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State Corporation Income Tax: Issues in Worldwide Unitary Combination (1984) 53, at 53-81. If the out-of-state firm concerns a foreign firm (i.e., non-US) two additional tests apply under the Foreign Commerce Clause: (1) the state tax should not prevent the US federal government from *"speaking with one voice when regulating commercial relations with foreign governments"*, and (2) the state tax should not cause foreign firms to be exposed to an *"enhanced risk of multiple taxation"*. See United States Supreme Court, *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983), and United States Supreme Court, *Barclays Bank PLC v. Franchise Tax Board of California*, 512 U.S. 298 (1994).

[1697] See 15 USC §381. This provision commonly referred to as PL 86-272 requires the physical presence of an out of state remote seller of physical goods situated within a state to establish its taxable presence for state income tax purposes. See also footnote 1567.

[1698] For an overview and some analysis, see the online working document of Annette Nellen entitled 'Economic Nexus; What actions have states taken to fill the void where PL 86-272 does not apply?', available at http://www.cob.sjsu.edu/nellen_a/taxreform/economic_nexus.htm.

[1699] See United States Supreme Court, *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) where the physical presence test for sales taxes is described. For some elaboration, see Neal A. Koskella, 'The Enigma of Sales Taxation Through the Use of State or Federal "Amazon" Laws: Are We Getting Anywhere?', 49 *Idaho Law Review* 121 (2012), at 124 et seq.

[1700] This has been referred to as 'agency nexus' or 'attributional nexus'. See in this regard United States Supreme Court, *Tyler Pipe v. Wash. Dept. of Rev.*, 483 U.S. 232 (1987), where the US Supreme Court held that *"the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales."* Worth noting is that in the area of US sales taxation this concept has recently been extended by some states by reference as 'affiliate nexus' to establish a taxable presence of out-of-state e-tailers for sales tax purposes. Under legislation referred to in practice as *"Amazon Laws"*, these e-tailers are considered to have 'click-thru nexus' within a state for sales tax purposes when such a 'vendor' is *"soliciting business through an independent contractor or other representative if the seller enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller;"* N.Y. Tax Law § 1101(b)(8)(vi). See for a discussion Neal A. Koskella, 'The Enigma of Sales Taxation Through the Use of State or Federal "Amazon" Laws: Are We Getting Anywhere?', 49 *Idaho Law Review* 121 (2012).

[1701] See George N. Carlson et al, 'Water's Edge Versus Worldwide Unitary Combination', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 1, at 20.

[1702] *Ibidem*.

[1703] Cf. Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

[1704] See Article 5(3)(b) of the United Nations Model Double Taxation Convention between Developed and Developing Countries.

presence' within the taxing state.[1705] This would include an out-of-state firm's intangible presence within the taxing state's territory, e.g., via the *"presence of its intangible property"* in that state.[1706] An example is the subjection to state income tax of an out-of-state trademark licensor lacking in-state physical presence for the purpose of imposing a state tax at source on the royalties that it receives on its out-of-state trademark licensing activities. The concept of 'economic nexus' has emerged following case law of the South Carolina Supreme Court validating in-state use of intangible property to establish nexus.[1707]

A third exception worth noting is the increasing popularity in US state income taxation of operating 'factor presence nexus' by reference to a firm's 'factor presence' within a state to establish tax jurisdiction for state income tax purposes.[1708] The concept of 'factor presence' – which is currently alien to international taxation – is further discussed in the following paragraphs.

Consequence: disconnect creates potential for 'nowhere income'

The consequence of the disconnect created between nexus standards and apportionment formulae is a potential mismatch between the establishment of a corporate taxpayer's taxable presence within a jurisdiction and the allocation of corporate profit to that jurisdiction. This mismatch triggers the risk of creating so-called 'nowhere income', i.e., the assignment of corporate income to a jurisdiction where the economic operator involved lacks a taxable presence, accordingly leaving the assigned income items untaxed.[1709]

Matters typically arise under the destination-based sales factor. That is, since the standards used in formulary systems to establish a taxable presence within a taxing jurisdiction commonly are predominantly oriented towards the origin state rather than the state of destination. The nexus standards used in formulary systems are commonly oriented towards business presence (supply-side) instead of customer presence (demand-side). A mere presence of the firm's customer(s) within the territories of a particular jurisdiction generally does not give rise to the establishment of a taxable presence within that jurisdiction. Recent exceptions may be found in the formulary systems in the US states, though – see hereunder.[1710]

Responses: 'reconnect' through throw-back rules and throw-out rules, profit attribution to taxable 'group members' (CCCTB)

The traditional legislative responses in the US and Canada, as well as under the CCCTB – rather than attempting to coordinate nexus and allocation rules – is to introduce an additional

[1705] For an overview of the concept of 'economic nexus' as currently applied by the US states, see the online working document of Annette Nellen entitled 'Economic Nexus; What actions have states taken to fill the void where PL 86-272 does not apply?', available at http://www.cob.sjsu.edu/nellen_a/taxreform/economic_nexus.htm.
[1706] See Supreme Court of South Carolina, *Geoffrey Inc. v. South Carolina Tax Commission,* 437 S.E. 2d 13 (1993). That would produce, in international taxation terms, a net based taxation of royalty income at source of a non-resident corporate taxpayer, a concept alien in international taxation.
[1707] See Supreme Court of South Carolina, *Geoffrey Inc. v. South Carolina Tax Commission,* 437 S.E. 2d 13 (1993), in which the court sanctioned the use of an economic presence standard for state tax purposes. The case involved an out of state (i.e., Delaware) trademark-holding company that licensed its trademarks for use by its South Carolina based affiliates. The Supreme Court of South Carolina observed that the trademark-holding company 'had purposefully directed its activities toward South Carolina'; 'the minimum correction required by due process is satisfied by the presence of intangible property'. The US Supreme Court refused to reverse this decision (it denied certiorari). The Supreme Court has yet to explicitly decide on issues relating to the use of economic nexus concepts for state income tax purposes. For an analysis of this case, see Jerome Hellerstein, 'Geoffrey and the Physical Presence Nexus Requirement of Quill', 8 *State Tax Notes* 671 (13 February 1995).
[1708] Matters have been shifting in the US approximately since the early to mid-2000s. For an overview of states currently operating factor presence standards to establish jurisdiction to tax, see the online working document of Annette Nellen entitled 'Economic Nexus; What actions have states taken to fill the void where PL 86-272 does not apply?', available at http://www.cob.sjsu.edu/nellen_a/taxreform/economic_nexus.htm.
[1709] For some background information and analysis, see Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 287-291.
[1710] For an overview of states operating factor presence standards to establish jurisdiction to tax, see the online working document of Annette Nellen entitled 'Economic Nexus; What actions have states taken to fill the void where PL 86-272 does not apply?', available at http://www.cob.sjsu.edu/nellen_a/taxreform/economic_nexus.htm.

set of rules reassigning the apportionment factors to a taxing jurisdiction where the firm involved does have a taxable presence. This is done to accordingly avoid the potential for creating nowhere income. This is sought to be achieved by means of so-called 'throw-back rules', or 'spread throw-back rules'; or alternatively, under the application of 'throw-out rules'.[1711]

Throw-back rules reapportion a factor that is attributed to a taxing jurisdiction in which a firm does not have a taxable presence to a taxing jurisdiction in which it does. The factor is basically 'thrown back' to the state where the firm does have a taxable presence. Under a throw-back rule, for instance, goods that are manufactured in one state and are shipped and sold in another state are reapportioned to the manufacturing state (origin state) if the seller does not have a taxable presence in the marketing state (destination state). Spread throw-back rules basically do the same but, under their application, the factor is thrown back proportionally to all jurisdictions in which the taxpayer involved has a taxable presence. Throw-back rules are in place in the US,[1712] Canada,[1713] and the CCCTB Proposal.[1714]

An alternative is the use of so-called 'throw-out' rules.[1715] These exclude an item from the formula which is otherwise included in an apportionment factor. The exclusion of such an item from the formula, i.e., from both the numerator and the denominator, has the effect of reassigning the corporate profits involved proportionally among all jurisdictions in which the taxpayer has a taxable presence. Throw-out rules, for instance, apply in the US with regards to proceeds from the commercialization of intangibles, e.g., royalties received in return for the licensing of intellectual property, dividend receipts on stock, or interest yields on bonds. These receipts may be thrown-out from the apportionment formula to the extent that they cannot be readily assigned to the taxpayer's income-producing activities.[1716]

[1711] See e.g. MTC Reg. IV.18.(c).(3): *"Where business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, the income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor,"* Multistate Tax Commission, *Allocation and Apportionment Regulations*, Adopted February 21, 1973; as revised through July 29, 2010, at 40. For some information and analyses, see Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 287-291, and William F. Fox et al, 'How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?', 53 *National Tax Journal* 139 (2005), at 155.

[1712] See, for instance, Article IV.16(b) Multistate Tax Compact, reapportioning the place of sales of tangible goods to the place of shipment if the taxpayer lacks a taxable presence in the jurisdiction where the purchaser is located: *"Sales of tangible personal property are in this State if (b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this State and (1) the purchaser is the United States Government or (2) the taxpayer is not taxable in the State of the purchaser."*

[1713] See Sec. 402(4)(b) Canadian Income Tax Regulations: *"(…) where the destination of a shipment of merchandise to a customer to whom the merchandise is sold is in a province or country other than Canada in which the taxpayer has no permanent establishment, if the person negotiating the sale may reasonably be regarded as being attached to the permanent establishment in the particular province or country, the gross revenue derived therefrom shall be attributable to that permanent establishment,"* and Sec. 402(4)(h) Canadian Income Tax Regulations: *"where gross revenue is derived from services rendered in a province or country other than Canada in which the taxpayer has no permanent establishment, if the person negotiating the contract may reasonably be regarded as being attached to the permanent establishment of the taxpayer in the particular province or country, the gross revenue shall be attributable to that permanent establishment."*

[1714] See Article 96(4) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS): *"If there is no group member in the Member State where goods are delivered or services are carried out, or if goods are delivered or services are carried out in a third country, the sales shall be included in the sales factor of all group members in proportion to their labour and asset factors."*

For some analysis, see Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, which refers to throwback rules at 7-8 (par. 17). Notably, in the US, *"[t]he throwback rule does not apply simply because a state chooses not to tax the sale. The sale will still be assigned to the destination state as long as that state has the jurisdiction to levy an income tax on the taxpayer regardless of whether the state, chooses to levy the tax,"* Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 23.

[1715] As an example, Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), refers to the using of a throw-out rule by New Jersey between 2002 and 2009, at 98. For some background information and analysis, see Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 287-291. See also Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 212-213.

[1716] See e.g., MTC reg. section IV.18.(c)(3).

In addition, worth noting is that the CCCTB seeks to further mitigate the need of using throw-back rules to tackle 'nowhere income issues' by assigning tax base to 'group members'. The approach differs from that taken under its US and Canadian counterparts which assign tax base to tax jurisdictions directly.[1717] Accordingly, tax base is assigned indirectly to the European Union Member States, i.e., via the attribution of profit to taxable group members. Group members are the companies that belong to the same 'CCCTB group', i.e., the group as defined under the CCCTB provisions, having a taxable presence within the European Union.[1718] The geographic presence of these group members is recognized by reference to their tax place of residence within a European Union Member State or their presence in a European Union Member State through a 'permanent establishment'. Corresponding with common international tax practices, the localization of a 'group member' by reference to its tax residence occurs on the basis of the respective company's 'place of incorporation' or its 'place of effective management'. The same holds true for the permanent establishment concept. Following international tax law approaches, the localization of a 'group member' on this basis occurs by assessing whether a business venture is being conducted by a non-resident group company through a 'fixed place of business' – like a store or branch – situated within the territories of a European Union Member State.

By assigning the apportionment factors under the CCCTB sharing mechanism to corporate entities having a taxable presence within a European Union Member State, nowhere income issues generally do not arise. The approach taken assures that the firm's entire taxable base is taxable.[1719] This, however, comes with a price: arbitrage – see hereunder.

Effect 'reconnect': new disconnect, now between factor assignment and firm input and firm output locations

The North American throw-back rules and throw-out rules as well as the indirect assignment of tax base to European Union Member States under the CCCTB perhaps resolve the arising nowhere income issues. However, these approaches create some problems of their own during the process as well. The 'reconnect' creates a new disconnect somewhere between the assignment of profit under the apportionment system and the locations of the firm's real inputs and firm outputs.

The assignment of profit to the jurisdictions where the firms involved have a taxable presence under the applied nexus standards does not necessarily correspond with the geographic locations of firm inputs and firm outputs. Under the application of the typical North American throw-back rules, for instance regarding the sales factor, sales are not attributed to the jurisdiction of destination. Rather, the application of these rules entails that the profits which are supposed to approximately relate to firm outputs in the destination jurisdiction are effectively assigned to the origin jurisdictions. That is, as the nexus concepts used are oriented towards the production states (permanent establishment, place of management, place of incorporation, et cetera), thereby reflecting the supply-side rather than the demand-side.

The traditional nexus standards used in formulary systems seem to miss that the sales factor is supposed to attribute profit to the demand jurisdiction. The arrival at such an approach would conceptually require the establishment of a nexus concept which makes reference to the location of the firm's customers to which it sells its (in)tangible products and services. This, for instance, would be achieved under a sales factor presence test.[1720]

[1717] For some background information and analysis, see Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, and Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.
[1718] See Article 86(1), Articles 4-6 and 54-55 in conjunction with Chapter XVI Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).
[1719] Cf. Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 225-226, referring to this as 'full accountability'.
[1720] See for a comparison, Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 202-205, Walter Hellerstein, 'State Taxation of Electronic Commerce', 52 *Tax Law Review* 425 (1996-1997), and Charles E. McLure, 'Implementing State Corporate Income Taxes in the Digital Age', 53 *National Tax Journal* 1287 (2000). See also

Moreover, although the nexus standards in place in the various formulary systems are oriented towards locating the production state, their design may be considered somewhat outdated, perhaps even flawed. They at least seem to operate unsatisfactorily in today's global economy. It has already been noted that the traditional nexus standards echo those applied in international taxation. It follows that the same inevitably holds true as to the problems that their application entail. Many of the traditional nexus standards in formulary systems fail to properly localize the jurisdiction of origin.

For instance, as regards the establishment of nexus within a tax-jurisdiction by reference to the company's place of incorporation (Canada, US, and CCCTB), effective management (CCCTB) or commercial domicile (US), it may be argued that such an approach is as arbitrary and vulnerable to manipulation as their counterparts are in international taxation.[1721] It may be deduced from well-known tax practices that the creation of nexus under such standards may not prove too difficult to achieve. That is, as this matter would likely revolve around ceremonial events like the chosen company laws governing the respective legal entity or the geographic location where the decisions concerning its governance are made. As said, these events may be directed with relative ease towards the tax jurisdiction(s) of choice, regardless of the location of real investment. Particularly, the international convergence of company laws, the cross-border mobility of corporate managers – 'fly-in-fly-out-management' – and the digitization of the global economy render these connecting factors rather meaningless and easily steered. As a result, the use of such nexus standards, also in formulary systems, seems to provide multinationals a readily available tool to establish a taxable presence in a 'home state' at their discretion for the purpose of influencing the tax base allocation under the apportionment mechanism.

The similar holds true with regards to the establishment of nexus within a tax-jurisdiction of out-of-state firms by reference to physical presence tests, such as the permanent establishment (Canada, CCCTB) or a trade or business (US). It may be deduced from known tax practices that this may also produce rather arbitrary results.[1722] The requirement of a physical-geographical presence, bricks and mortar, reflects yesterday's economic realities. As discussed, the emergence of internet and e-commerce diminished the need for establishing a tangible presence within a country to enter its market.[1723] A virtual presence through a website may suffice; particularly where it concerns the supplies of IT-services or e-tailed goods. As a consequence, the proceeds from e-commerce activities may virtually be left untaxed in the 'host state'. Like their equivalents in the international tax regime, the physical presence concepts in the formulary systems, like the permanent establishment threshold, miss the digitization of the economy completely.[1724]

Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 15 (par. 61), Multistate Tax Commission Policy Statement 02-02, *Ensuring the Equity, Integrity and Viability of State Income Tax Systems*, Amended October 17, 2002, and Multistate Tax Commission, *Federalism at Risk, A Report of the Multistate Tax Commission*, June 2003, at Appendix D. Please note that this analytically regardless of the presence of legislative acts to the contrary, such as 15 USC §381, Sec. 402 Canadian Income Tax Regulations, or Articles 4-6 and 54-55 in conjunction with Chapter XVI Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).

[1721] See for this argument in the context of the CCCTB proposal, Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

[1722] *Ibidem*.

[1723] See for a comparison e.g., the use of this argument in the context of international taxation Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1999-2000), at 1596.

[1724] See e.g. Lee A. Sheppard, 'The Digital Economy and Permanent Establishment', 70 *Tax Notes International* 297 (22 April 2013), Charles McLure, Jr., 'Alternatives to the concept of permanent establishment', 1 *CESifo Forum* 10 (2000), at 10-16, Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), and Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006), at 266-279. In its recent discussion draft, the OECD suggests to modify the permanent establishment threshold by introducing a new tax nexus standard that refers to a 'significant digital presence'. That paves the way for introducing alternative permanent establishment threshold, such as, according to the OECD, i.e., the 'virtual fixed place of business permanent establishment', the 'virtual agency permanent establishment' and the 'on-site business presence permanent establishment'; see OECD, OECD Committee on Fiscal Affairs, *Public Discussion Draft BEPS Action 1: Address the tax challenges of the digital economy, 24 March – 14 April 2014*, OECD Publishing, Paris, 24 March 2014, at 65. In its final report however the OECD seems to indicate

Perhaps, in the end, only the presence of the firm's workers exercising their employment contracts may be of some help in providing a proxy to localize income at origin, for instance by reference to a quantitative factor presence test (see section 6.3.3.4 for the same argument). As discussed earlier, under a strict origin approach the profits are where the significant people are. Conceptually, this calls for a 'labor factor presence test', which refers to, e.g., the operations undertaken by the multinational's workforce within a country (e.g., 'working days test') – subject to a *de minimis* threshold ('payroll country A exceeds amount €x').[1725]

Effect of new disconnect: potential for artificial profit shifting through factor shifting

The arbitrariness created by disconnecting the factor allocation from the input and output locations may be utilized to manipulate the system. The artificial relocation of corporate profit into the relatively lower tax jurisdiction may be achieved by engaging into factor shifting operations. The artificialities may be exploited both by firms (tax planning arrangements) and taxing jurisdictions (undue tax competition responses).

The potentials for engaging in artificial tax planning operations are essentially all rooted in the use of the same nexus concepts as utilized in international taxation, i.e., the tax place of residence and the permanent establishment. These allow for the shift of formula factors without the need to substantially alter the underlying investments and trade activities. Please allow me to illustrate things by referring to the sharing mechanism in the CCCTB proposal.

If the CCCTB proposal, for instance, would enter into force as it is currently drafted, there may be a risk that multinationals could game the formulary system by engaging into factor manipulation operations.[1726] As the European Union Member States may only be able to respond to this by lowering their corporate tax rates,[1727] this may potentially result in undue governmental tax competition responses. The arbitrage may involve:

1. 'Labor factor manipulation' through 'payroll group members';
2. 'Sales factor manipulation' through 'beneficiary group members'.

Ad 1. 'Labor factor manipulation' through 'payroll group members'. Under the CCCTB's labor factor, employees and payroll would be attributed to the group member(s) from whom the employees receive their remunerations. To the extent that employees substantially exercise their employment contracts under the *"control and responsibility"* of group member(s) other than the group member(s) paying the salaries and wages, the factor would be allocated to the

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that reform proposals would need to be found within the existing international tax framework; see OECD, OECD Committee on Fiscal Affairs, *OECD/G20 Base Erosion and Profit Shifting Project; Addressing the tax challenges of the digital economy*, OECD Publishing, Paris, 16 September 2014, at 18 and 149.

[1725] The approach taken in Article 15 OECD Model Tax Convention, perhaps, could provide some inspiration in designing such an alternative nexus rule.

[1726] For an extensive analysis, see Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

[1727] It is noted that profit shifting through factor manipulation may be infeasible to be struck down by other means. The CCCTB's anti-abuse provisions like the 'General Anti-Abuse Rule' in Articles 80-83 of the CCCTB Proposal – targeting artificial legal arrangements set-up to avoid tax – seem to merely refer to excessive behaviors concerning tax base calculation. Consequently, the abuse of apportionment rules seems to fall outside the confines of the CCCTB's anti-abuse rules; Cf. *Comment by Dennis Weber on the CCCTB Propos*al, Vakstudie H&I, Highlights and Insights on European taxation, 2011/6.1, at 57. (Perhaps some room upholds under the European Union's abuse of law doctrine. Matters seem indistinct in this area. For some analysis see Peter Harris, 'The CCCTB GAAR: A Toothless Tiger or Russian Roulette?', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) , at 271-297. Furthermore, the 'Safeguard Clause' in Article 87 of the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS), which is directed at correcting unfair outcomes under the general formula seems to apply only when all the European Union Member States' authorities involved agree. Moreover, some uncertainties exist as to whether the rulemaking authority of the Commission laid down in Article 97 regarding the sharing mechanism would enable it to adopt substantial changes to the legislative act. I am not a cynic but it may be fair to say that it remains to be seen how much room will effectively be available at the end of the day to resolve issues that might emerge concerning multinational factor manipulation and European Union Member State tax competition responses.

first mentioned group member(s).[1728] In regards to the latter, the exception would be the meeting of the required reassignment thresholds. Please note that the jurisdiction of origin where the firm's workers physically exercise their employment contracts seems irrelevant.

The application of such an apportioning key may invite multinationals to set-up and establish for tax purposes 'payroll group members' in the comparatively lower European Union taxing jurisdiction to artificially steer CCCTB tax base into that jurisdiction.[1729] That is, even though the firm's workers may actually exercise their employment contracts across the European Union. Perhaps, this may even hold up regarding workers that are posted on the basis of intra-group secondment contracts. Note that the presence of workers within a country does not in itself trigger the presence of a permanent establishment.[1730]

As the labor factor in the CCCTB-proposal assigns one-third of the European Union-wide tax base, the consequence of using such a labor factor allocation rule may be that one-third of the European Union-wide tax base becomes instantly mobile as of the entry into force of the CCCTB.[1731]

Ad 2. 'Sales factor manipulation' through 'beneficiary group members'. Further, under the proposed CCCTB sales factor, revenues from – loosely phrased – portfolio investments and hedging transactions, as well as exempt revenues like gross proceeds from (third country) shareholdings (e.g., dividends, capital gains)[1732] would be attributed to the group company that qualifies as the *"beneficiary"*. That is, to the extent that the revenues have been earned *"in the ordinary course of trade or business"*.[1733]

Notably, as I am not entirely sure how to interpret the 'beneficiary' receiving such revenues 'in the ordinary course of trade or business', I tentatively follow the suggestions that Hellerstein has submitted in this regard,[1734] as well as the analogous guidance provided by the Court of Justice of the European Union in the area of value added taxation on portfolio investment activities.[1735] Using transfer pricing terminology I take it to mean that these types of gross-receipts are attributed to the group member which beneficially owns these,[1736] and functionally performs the multinational's shareholding management functions, treasury functions, cash-pooling functions and/or functionally manages the multinational's hedging positions. These types of functions performed may be considered to constitute key components of the firm's ordinary trade or business operations. At least, they do in the US formulary systems.[1737] Please note that the jurisdiction of destination where the firm's customers utilize or consume the services and goods provided to them seems irrelevant.

[1728] Articles 90-91 Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).

[1729] See for a comparison Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 242-243.

[1730] The risk of factor manipulation through the setting-up of payroll companies to which the workforce is legally assigned may occur to the extent that the terms 'control and responsibility' ultimately would be interpreted narrowly, for instance by reference to the exercising of legal control and responsibility. Further, this may hold even if the terms are interpreted in a less restricted sense, i.e., by allocating the tax base to the group member to whom the economic risks involving the utilization of the multinational's workforce have been assigned. In transfer pricing it is well-known that the economic risks involving economic activities are quite mobile and can be legally assigned to group companies per the multinational's discretion.

[1731] The reality of such a planning tool may ultimately depend on the interpretation of the terms 'control and responsibility'. The issue for instance may be substantially mitigated to the extent that these would need to be interpreted as corresponding with the location where the employment contracts are physically performed. However, as this does not seem to correspond with the language used the potential for arbitrage may be considered present – at least theoretically.

[1732] Article 11(c)(d) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).

[1733] Article 95(2) in conjunction with 96(3) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).

[1734] See Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 237-241.

[1735] See, Court of Justice cases C-60/90 (*Polysar*), C-155/94 (*Wellcome Trust Ltd*), C-306/94 (*Régie Dauphinoise*), C-80/95 (*Harnas & Helm*), and C-142/99 (*Floridienne*).

[1736] Note that I refer by analogue to the 'beneficial ownership' concept in international taxation.

[1737] See Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 239. To substantiate the argument, Hellerstein refers by analogue to *Microsoft Corp. v. Franchise Tax Board*, 39 Cal. 4th 750, 139 P.3d 1169, 47 Cal.

The use of such a sales factor apportioning key may invite multinationals to set-up and tax-establish 'beneficiary group members' in the comparatively lower European Union taxing jurisdiction. That is, to subsequently functionally assign the portfolio investments, hedge positions, and shareholdings to that 'beneficiary group member' to steer CCCTB tax base into that jurisdiction.[1738] Practical experiences in transfer pricing reveal that setting up such an arrangement may not be too difficult to achieve. The mobile and intangible characteristics of the assets involved, their potential to produce significant turnover, and the moderate extent of labor force required to perform the relevant functions involved, may perhaps accordingly render the proposed CCCTB sales factor quite vulnerable and subject to manipulation.

Interestingly, the practical experiences in US state income taxation have already fueled some thoughts about the planning strategies that multinationals may pursue under the CCCTB sales factor. Examples by analogue may be found in US state income tax practice.[1739] First, reference can be made to a California state income tax case involving a software company which obtained gross revenues from its sales of short-term portfolio investments through the performance of a treasury function.[1740] It performed the function involved in the State of Washington where the firm had its headquarters (the location of the company's 'commercial domicile'). The portfolio investment revenues accounted for 73% of total gross receipts (while producing less than 2% of net income). These revenues accordingly overshadowed the company's core outputs, software sales. As a result, significant amounts of state income tax base were at risk of being shifted towards Washington which would leave it untaxed (as Washington does not operate a state income tax). The California Supreme Court resolved the matter by requiring the software company to apply the sales factor to the net portfolio investment income. Referring to the language used in the CCCTB proposal – *"total sales"*, *"proceeds"*, *"revenues"*[1741] – this solution may however be unavailable under the CCCTB.

Second, reference can be made to another California state income tax case, which deals with the application of the sales factor on gross receipts from the sales of commodity futures that had been made to hedge against price fluctuations.[1742] The case involved an enterprise engaged in the sale of grain products like flour and cereal. The company engaged in hedging transactions to insure itself against fluctuations in the cost prices of the raw grain materials that it used in its business process. These enabled it to cancel out grain price fluctuation risks to stabilize profit margins. The company managed its hedging positions at its headquarters located in Minnesota. The Court of California concluded that the gross receipts from the selling of commodity futures were included in the sales factor. As the undertaken hedging transactions produced substantial turnover (not profit), a significant part of state income tax base was shifted from California to Minnesota. The California state income tax legislature responded by excluding amounts received from such hedging transactions from the sales factor per 1 January 2011.[1743] Assuming that this issue may arise under the CCCTB by analogy – and I do not really see why it would not – the CCCTB appears to be in need of amendment at this point as well.

Rptr. 3d 216 (2006). Analogues to case law of the Court of Justice on European Union value added taxation, the performing of portfolio asset management and shareholding management functions may perhaps be considered part of ordinary trade or business operations where these functions performed *"are effected as part of a commercial share-dealing activity, in order to secure a direct or indirect involvement in the management of the companies in which the holding has been acquired or where they constitute the direct, permanent and necessary extension of the taxable activity"*. See, Court of Justice cases C-60/90 (*Polysar*), C-155/94 (*Wellcome Trust Ltd*), C-306/94 (*Régie Dauphinoise*), C-80/95 (*Harnas & Helm*), and C-142/99 (*Floridienne*).

[1738] See for a comparison Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 242-243.

[1739] References to US state income tax case law and legislation were drawn from Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 237-241.

[1740] See *Microsoft Corp. v. Franchise Tax Board*, 39 Cal. 4th 750, 139 P.3d 1169, 47 Cal. Rptr. 3d 216 (2006).

[1741] See Article 95 Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).

[1742] *See General Mills v. Franchise Tax Board*, 172 Cal. App. 4th 1535, 92 Cal. Rptr. 3d. 208 (1st Dist. 2009). Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, addresses an equivalent issue at 286.

[1743] Cal. Rev. & Tax Code § 25120(f)(2)(L) (Westlaw 2011).

In addition to these US-style planning opportunities, treasury activities and hedging activities, the CCCTB sales factor also seems to produce some novel planning opportunities of its own. That is, with regards to the apportionment of shareholding revenues such as dividends and capital gains to the beneficiary. Such shareholding proceeds may be exempt from the CCCTB tax base under the 'participation exemption regime'.[1744]

The apportionment of tax base by reference to the group member functionally performing the multinational's (third-country) shareholding management functions may trigger the risk of initiating a process whereby intra-group third-country transactions are set-up to inflate the sales factor. Under the composition of the proposed sales factor, multinationals would seem enabled to inflate that factor by establishing an ongoing process of extracting dividend streams from their (third-country) shareholdings financed with capital contributions.[1745] Such an establishing of circular dividend and capital contribution streams do not seem to affect the tax base in an upward sense, yet are recognized for CCCTB tax base sharing purposes under the sales factor. The receipts from such artificial sales factor inflating 'shareholding-revenue-carousels' have the potential of fully eclipsing real outputs.

The CCCTB proposal accordingly seems to potentially grant multinationals complete discretion as to the intra-European Union attribution of the sales factor. The CCCTB would accordingly provide multinationals some readily available tools to engage in artificial tax base shifting. The consequence may be that an additional one-third of the European Union wide tax base instantly becomes mobile as of the entry into force of the CCCTB Directive.[1746]

If the aforementioned arbitrage holds up, potentially two-thirds of the European Union-wide tax base is at risk of being artificially shifted across the European Union upon the CCCTB's entry into force. This may be considered particularly problematic since it may not be feasible to effectively strike down profit shifting through factor manipulation under the CCCTB's anti-abuse rules.[1747] As the European Union Member States may only have the tax rate at their disposal to influence multinational location decisions within the European Union, perhaps the CCCTB may accordingly initiate an unforeseen intra-European Union 'race to the bottom'. This matter may arise in addition to the vulnerability of the European Union tax base being subjected to traditional base erosion and profit shifting operations across the water's edge – i.e., since the CCCTB would apply a traditional SA/ALS corporate tax system in third country relations.

Resolve matter through aligning nexus and allocation by means of factor presence tests

Perhaps therefore, matters need to be resolved via some other means. I would favor the coordination of nexus and allocation standards in line with input and output locations through the utilization of quantitative 'factor presence tests'.[1748] Under such an approach, as said, a

[1744] Article 11(c)(d) in conjunction with 95(2) and 96(3) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).

[1745] The dividend streams may be financed with equity but perhaps even with intra-group third-country debt. The financing of such cash-carrousels with intra-group debt may potentially even negatively affect the European Union tax base as the outbound intra-group interest payments involved may be tax-deductible. Perhaps such interest deductions could be restricted under the anti-abuse rules.

[1746] The reality of such a planning tool may ultimately depend on the interpretation of the terms 'beneficiary', 'the ordinary course of trade or business', 'total sales', 'proceeds', 'revenues', and 'exempt revenues'. The issue may be substantially mitigated to the extent that these would need to be interpreted as not to include portfolio investment proceeds, hedging transactions proceeds and revenues to which the CCCTB participation exemption applies. However, as this does not seem to correspond with the language used in the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS), arbitrage potentials may be considered present – at least theoretically.

[1747] As said, these rules do not seem to address the artificialities that may arise concerning the application of the sharing mechanism.

[1748] See e.g. Walter Hellerstein, 'State Taxation of Electronic Commerce', 52 *Tax Law Review* 425 (1996-1997), and Charles E. McLure, 'Implementing State Corporate Income Taxes in the Digital Age', 53 *National Tax Journal* 1287 (2000), and Multistate Tax Commission, *Federalism at Risk, A Report of the Multistate Tax Commission*, June 2003, at Appendix D. See for a comparison Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 202-205, as well as Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 56, *Report and overview of the main issues that emerged during the discussion on the sharing mechanism SG6 second meeting – 11 June 2007*, Taxud E1 OP, CCCTB\WP\056\doc\en, Brussels, 20 August 2007, at 10-11 (par. 38-40)

taxpayer would have a taxable presence within a taxing jurisdiction if it has any of the formula factors (property, payroll, sales), or a combination thereof located within that jurisdiction.

The establishment of nexus by reference to such a test could be subject to a quantitative *de minimis* threshold: 'wages paid, asset values, revenues in tax jurisdiction A exceed amounts $x, y, z'.[1749] The US Multistate Tax Commission, for instance, suggests threshold amounts of $50,000 regarding the property and payroll factors and $500,000 regarding the sales factor.[1750] A conceptual equivalent of this approach may be found in the distance sales rules in European Union value added taxation. These establish jurisdiction to tax in a Member State when the sales in that state exceed a quantitative threshold of either €35,000 or €100,000.[1751] To make sure that all profits are geographically assigned, including the cases where the *de minimis* threshold otherwise is not met, one may consider using as a back-stop rule that nexus is alternatively established when the aggregate formula attributes to the respective taxing jurisdiction more than a certain percentage of the firm's overall profit (e.g. 25%).[1752]

Such an approach should merit some consideration for two reasons. First, the alignment of nexus and allocation rules would eliminate the opportunities for creating nowhere income. It would accordingly render superfluous the need to adopt the 'throw-back rules', 'spread throw-back rules', or 'throw-out' rules to reassign tax base to jurisdictions that have nexus to tax it, as found in the US and Canadian formulary systems. It would similarly render superfluous the perceived need to assign tax base to 'group members', as the CCCTB proposal does.

Second, to the extent that the aligned nexus and allocation rules would match the firm input locations and firm output locations, which would render moot the opportunities to engage in artificial factor shifting operations. The issue of artificially shifting the tax base through the set-up of factor manipulation operations would be resolved, since the shifting of corporate profit in that event would require the relocation of the firm's workers or assets, a shift of real inputs accordingly, or the relocation of the firm's marketplace, a shift of real firm outputs accordingly.

The introduction of quantitative factor presence tests in the international tax regime to replace the archaic 'tax place of residence concept' and the 'permanent establishment concept' would indeed be a novelty. Nevertheless, in my view, there is no proper reason not to consider it. The replacement of the current nexus standards in international taxation with factor presence tests, such as those applied today in US state income taxation, would merely be a response to 'today's reality of an increasingly global world, suiting the nature of the global economy'.[1753] It should not be forgotten that the current international tax standards do not match 21st century business realities.

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and Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 15 (par. 61). For some further comparison, see Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), and Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold', 60 *Bulletin for International Taxation* 266 (2006), at 266-279.

[1749] See for a comparison Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 287: *"In general, a taxing jurisdiction should eliminate opportunities that taxpayers may have for creating nowhere income by coordinating the apportionment rules with the nexus rules. For example, a taxpayer should be treated as having a taxable presence in a country if it has a property, payroll, or receipts factor located in that country."* See also Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 203: *"Such a nexus test would realize the ideal that the nexus requirement should conform with the method of profit attribution."*

[1750] Cf. Multistate Tax Commission, *Federalism at Risk, A Report of the Multistate Tax Commission*, June 2003, at Appendix D.

[1751] See Articles 33 and 34 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

[1752] Cf. Multistate Tax Commission, *Federalism at Risk, A Report of the Multistate Tax Commission*, June 2003, at Appendix D.

[1753] This phrase has been drafted in the style of Avi-Yonah and Clausing. See Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at sections 3.2.1. and 4.3.

6.4.4.2.3 *Exploring suitable proxies for locating and evaluating firm inputs and firm outputs*

Components of factor presence tests: 'scope', 'evaluation', and 'location'

How should these factor presence tests be defined? Their purpose, obviously, should be to match the firm inputs at origin and firm outputs at destination as closely as possible. What could be suitable proxies for classifying, evaluating and locating the payroll factor, asset factor and revenue factor?

For this purpose, three components need to be taken into consideration. One needs to respectively address the formula factors' scope (what?), evaluation (how much?), and location (where?). The factors should be classified, evaluated, and localized. This holds true for both the origin-based payroll and asset factors, as well as the destination-based revenue factor. Let us proceed and elaborate somewhat further on the design of the formula factors. That is, would one contemplate to include all three factors in the formula. A double factor formula or a single factor formula, for instance, could be considered also – see further hereunder.

Payroll factor: employees, employee remunerations, location(s) of work performed

Scope. As the payroll factor seeks to reflect the contribution of the production factor of labor to the generation of the firm's corporate profit,[1754] its scope, in substance, should cover the firm's employees.[1755] The factor would include all persons that are in an employee-employer relationship with the multinational firm, including managers and directors.[1756] The factor, accordingly, would basically address those persons (employees) who agreed under an employment contract to:

- personally perform economic activities;
- on behalf, for the account and under the control c.q. supervision and responsibility of the multinational firm (employer);
- for a specific or indefinite period of time;
- in return for a remuneration (wage, salary, et cetera).

The payroll factor should not include the relationships of the firm with truly self-employed persons, as those relationships constitute services performed for the firm by independent contractors.[1757] That obviously holds up only if and to the extent that these persons, substantially, cannot be considered employees in substance.[1758] *"Taxpayers should not be permitted to artificially deflate the amount included in the payroll factor through the use of so-*

[1754] Cf. Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 47.
[1755] See for a comparison Sec. 402(7) Canadian Income Tax Regulations, Article 90 CCCTB Proposal, and Article IV(1)(c) Multistate Tax Compact.
[1756] That is, provided that these directors do not have a controlling shareholding in the ultimate parent company. Notably, following the suggestions of Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 8 (par. 22), Article 90(3) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS) sets forth that *"[t]he definition of an employee shall be determined by the national law of the Member State where the employment is exercised"*. This produces the potential for mismatches and double (non-)taxation issues as a consequence. The path chosen in the CCCTB proposal should therefore be considered a route not to be followed.
[1757] See Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 8 (par. 24), and Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 21: *"Payroll excludes payments made to independent contractors or to any person who is not classified as an employee, but it may include payments made to leased employees."*
[1758] For instance, the Canadian system for this purpose includes in the payroll factor *"services … that would normally be performed by employees of the corporation."* See Sec. 402(7) Canadian Income Tax Regulations.

called independent contractors who, in substance, act as employees."[1759] To the extent that the services are obtained from truly independent contractors, these 'leased' services, conceptually, should be taken into account in the firm's asset factor. That is, since the firm's entitlements under the service contracts involved would be part of the firm's debits.[1760]

Please note that the definitional issues involving the scope of the labor factor are not indigenous to formulary apportionment. Actually, matters are conceptually similar to the classification issues that arise under the application of the distributive rules for employment income in the double tax convention networks of countries that follow Article 15 of the OECD Model Tax Convention. That is, although matters in the area of formulary apportionment in this respect are – or at least, should be – seen from the perspective of the multinational firm when attributing its profit geographically on the basis of a formulary approach. Under Article 15 of the OECD Model Tax Convention, the perspective of the respective employee is taken.

Valuation. The payroll factor seeks to address the remunerations that the firm pays in return for utilizing its workers to approximate the contributions of the workforce to the profitability of the multinational group. The factor accordingly needs to be evaluated by reference to actual employee compensation,[1761] and should include wages, salaries, commissions, bonuses, fringe benefits and other emoluments that are paid to the firm's employees.[1762] Both employee compensation in cash and kind should be taken into consideration. Company cars, computers and telephones, et cetera, would need to be taken into account to the extent that these items are available for the employee's personal use. These items should be evaluated by reference to the costs incurred, as the remunerations paid by the firm are the subject of the assessment.[1763] Further, for the same reason the costs involving employer-provided social security and pension entitlements should be considered as on the payroll as well.[1764]

Notably, as it concerns the measuring of inputs, the payroll factors in formulary mechanisms do not aim to assess the relative productivity of the workforce, i.e., the 'fair value' of the worker(s); something, I can imagine, that is very difficult or perhaps even impossible to measure. The payroll factor addresses the labor costs involved to approximate the location of profit by reference to the contribution of labor to profit generation. It appreciates that costs do not explain profit; it modestly makes use of it as a proxy. The consequence is that relatively

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[1759] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 285.

[1760] *Ibidem*. McIntyre sets forth that the use of 'leased' persons *"presents problems similar to the problems that arise under the property factor from the use of leased property."* Further McIntyre argues that *"[u]nfortunately, the American states generally do not treat leased employees the way they treat leased property. Instead, they typically omit contract employees from the payroll factor, thereby providing taxpayers with an opportunity to game the system."* Contra, Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 56, *Report and overview of the main issues that emerged during the discussion on the sharing mechanism SG6 second meeting – 11 June 2007*, Taxud E1 OP, CCCTB\WP\056\doc\en, Brussels, 20 August 2007, at 4 (par. 12), which considers to include in the payroll factor employees that are leased from unrelated businesses.

[1761] Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, seems to take this point of departure also as it refers to the using all labor costs that are deducted from the tax base at 8 (par. 25).

[1762] Cf. Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 285. In the US, the factor is evaluated by reference to *"wages, salaries, commissions and any other form of remuneration paid to employees for personal services"*. See Article IV(1)(c) Multistate Tax Compact. The Canadian system refers to *"salaries and wages",* see Sec. 402(3)(b) Canadian Income Tax Regulations.

[1763] Please note that the perspective from the firm is taken, not that of the employee's. In cases where the employee's perspective needs to been taken, for instance, for the purpose of measuring its wage income for wage tax purposes, the remunerations in kind by reference to retail values merits consideration.

[1764] Cf., e.g., Article 91(4) CCCTB Proposal: *"[t]he term "payroll" shall include the cost of salaries, wages, bonuses and all other employee compensation, including related pension and social security costs borne by the employer."* See for a comparison Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 47. See also Robert A. Petersen, 'Comments on Miller', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 167, at 168. Petersen mentions that 'in the US, the employer's costs for social security and other government-mandated insurance programs are excluded from the formula'. Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, notes at 21 that the Canadian system does not include unemployment insurance contributions and pension plan contributions in the payroll factor.

greater parts of the taxable base would be attributed to taxing jurisdictions having relatively higher wage levels. This has triggered in the literature the question of whether the number of employees should be taken into consideration in the composition of the payroll factor to account for wage level differentials in countries.[1765] This, for instance, has been done in the CCCTB Proposal.[1766] In my view, the number of workers should not be taken into consideration. Wage level differentials are a consequence of labor market imperfections – or, i.e., at least an issue analytically separate from taxation. It follows that these should not be sought to be 'corrected' through a tax base allocation system.[1767]

Location. As the payroll factor seeks to reflect the contribution of the firm's workforce in the origin state, the factor should localize the payroll where the firm's employees actually exercise their employment contracts.[1768] The factor should accordingly aim to identify the location(s) of work performed. To the extent that a particular employee exercises its employment contract in various jurisdictions, some kind of attribution needs to be undertaken. Perhaps one may consider matching payroll with the location of work performed for this purpose by reference to some causality key. For administrative convenience reasons, however, I would favor doing this alternatively. I would advocate adopting a fractional approach, which refers to the respective worker's working days within the taxing jurisdictions involved during the respective taxable period in the numerator, and the total number of working days in that period in the denominator, i.e., a 'working days test'.[1769] Sick days should be disregarded in my view, as

[1765] See Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 47, Charles E. McLure Jr., 'Replacing Separate Accounting and the Arm's Length Principle with Formulary Apportionment', 56 *Bulletin for international taxation* 586 (2002), at 594. See for some discussion on the appropriateness of adjustments to account for wage level differentials Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 8 (par. 26), Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 52, *An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB*, Taxud E1 AAG-GR-FF, CCCTB\WP\052\doc\en, Brussels, 27 February 2007, at 7 (par. 28-30), and Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 6 (par. 15).

[1766] See Article 90(1) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS), which refers to a labor factor that consists of two equal weighted elements: payroll and number of employees: *"The labour factor shall consist, as to one half, of the total amount of the payroll of a group member as its numerator and the total amount of the payroll of the group as its denominator, and as to the other half, of the number of employees of a group member as its numerator and the number of employees of the group as its denominator."*

[1767] Cf. Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.

[1768] Cf. Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 6 (par. 15), and Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 8 (par. 27), as well as Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38, and Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 47.

[1769] The CCCTB, the Canadian provinces and the US states follow dissimilar procedures. As discussed in the above, the CCCTB does something dissimilar also. The CCCTB's labor factor (Articles 90-90 CCCTB Proposal) arbitrarily attributes employees and payroll to the group member(s) from which the employees receive their remunerations. To the extent that employees substantially exercise their employment contracts under the *"control and responsibility"* of other group member(s) than the group member(s) paying the salaries and wages, the factor would be allocated to the first mentioned group member(s). The discrepancy with the location of work performed triggers the arbitrage issues involving the 'payroll group members' as referred to in the head text. For the Canadian approach see Sec 402(3)(b) Canadian Income Tax Regulations that refers to *"employees of the permanent establishment"*. Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, notes at 22 that *"[t]he provinces generally assign salaries and wages to the permanent establishment where the employee normally reports to work. However, salaries and wages for head office administration are assigned to the location of the head office"*. The US states typically operate rules in this area equivalent to Article IV.14 Multistate Tax Compact. These diverge from the approach taken in the head text as well: *"Compensation is paid in this State if: (a) the individual's service is performed entirely within the State; (b) the individual's service is performed both within and without the State, but the service performed without the State is incidental to the individual's service within the State; or (c) some of the service is performed in the State and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the State, or (2) the base of operations or the place from which the service is directed or controlled is not in any State in which some part of the service is performed, but the individual's residence*

those days are not working days. The same should hold for holidays and any other types of absences, since the respective employee is not productive for the firm when absent c.q. not working – regardless of whether or not he receives wages while absent.

Please note that the issues involving the localization of the labor factor are not indigenous to formulary apportionment either. Actually, matters are conceptually similar to the issues in localizing employment income under the relevant distributive rules in the double tax convention networks of countries that follow Article 15 of the OECD Model Tax Convention. In fact, with regards to the individual income taxation of cross-border workers' wages, the approaches for this purpose taken in international tax practice also often refer to the employee's working days in the source state.[1770]

This being said, matters boil down to the following nexus/allocation labor factor: '$\text{payroll State A} = \text{payroll} * \frac{\text{working days employee(s) in State A}}{\text{overall working days employee(s)}}$'.[1771] For administrative convenience reasons, incidental work performed by the firm's workers in a certain tax jurisdiction could be disregarded under a *de minimis* nexus threshold rule. Such a rule could be defined, for instance, as 'nexus if payroll state A exceeds amount $, ¥, or €x' (e.g., $, ¥, or €50,000),[1772] or 'nexus, alternatively, if the aggregate formula attributes more than x% of profits' (e.g., 25%) – i.e., the latter would apply if the first mentioned nexus standard has not been met.[1773] Notably, the currency used would differentiate per taxing state – currency issues are discussed hereunder.

That would perhaps effectively cancel out artificial tax base shifting through labor factor manipulation, for instance under the CCCTB by using 'payroll group members'. Viz., the shifting of profit through the shifting of the payroll factor in that event would require a physical relocation of the multinational's workers, a shift in real inputs accordingly.

Asset factor: firm debits, costs incurred, location of functional utilization

Scope. As the asset factor seeks to reflect the contribution of the production factor of capital to the generation of the firm's corporate profit, its scope should cover *all* the firm's debits, in my view.[1774] That is, theoretically, regardless of the (insurmountable) problems that arise would this approach be chased after to be implemented in practice – see hereunder. In principle, the factor should include all the firm's property, regardless of whether it appears on the firm's commercial balance sheets; i.e., otherwise the renowned 'value gap' in commercial accounting, produced by items that do not appear on the balance sheets for instance, would

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is in this State." Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 97 notes that a few US states apply throwback rules for payments that are attributed to jurisdictions in which the taxpayer is not taxable. These are necessary to the extent that states operate nexus concepts on the basis of which the presence of a workforce does not establish a taxable presence. As discussed in the above, I would favor the coordinating of nexus and apportionment rules via 'factor presence tests'.

[1770] The inspiration for the approach taken in localizing the payroll-factor has indeed been found in the established case law of the Dutch Supreme Court – e.g., Dutch Supreme Court, Hoge Raad, 23 September 2005, No. 40179, Beslissingen in Belastingzaken Nederlandse Belastingrechtspraak 2006/52 – on the attribution of wage income under the distributive rules for employment income in the Dutch double tax convention network. These are equivalent to Article 15 of the OECD Model Tax Convention. See for a comparison, Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 52, *An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB*, Taxud E1 AAG-GR-FF, CCCTB\WP\052\doc\en, Brussels, 27 February 2007, at 6 (par. 27): *"Among the possible methods, it was considered taking into account the rules that would be applicable to the personal income of the employee (Article 15 of the OECD Model Tax Convention)."*

[1771] Please note that to the extent the application of the fraction involves a worker that is operational solely within a single state, the application of the fraction with regard to that worker would be 1.

[1772] That would for instance cancel out short-term business trips from the equation in the majority of cases.

[1773] Cf. Multistate Tax Commission, *Federalism at Risk, A Report of the Multistate Tax Commission*, June 2003, at Appendix D.

[1774] Cf. Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 211. Mayer makes an exception for non-productive assets. He would exclude those from the property factor. I do not see the need for that, as I fail to recognize why profit-optimization driven multinational firms would own unproductive assets in the first place. If an asset would not be income-producing the firm would dispose of it. That renders superfluous the necessity for a rule excluding such assets from the property factor.

leak into the formulary system.[1775] The asset factor would accordingly theoretically need to include the multinational firm's:

- current assets:
  - current tangible assets (e.g., inventories);
  - current monetary assets (e.g., cash and cash equivalents, short-term portfolio investments – shareholdings, receivables, securities, derivatives, et cetera – and prepaid expenses);
  - current intangible assets (e.g., short-term license interests and short-term operational leasehold interests, short-term franchises).
- non-current (fixed) assets:
  - fixed tangible assets (e.g., land, buildings, machinery, equipment, vehicles);
  - fixed monetary assets (e.g., long-term non-portfolio investments, for instance shareholdings held as a capital asset – 'participations');
  - fixed intangible assets (e.g., goodwill, computer software, long-term license interests and long-term financial leasehold interests, long-term franchises, as well as intellectual property, such as *in rem* intellectual property rights like patents, trademarks, trade names, et cetera, and *ad personam* intellectual property rights like commercial know-how and technical know-how).

The scope of the asset factors in the formulary systems that are in place today is significantly limited, however. In the US systems, for instance, the asset factor is generally limited to *"real and tangible personal property owned or rented and used during the tax period"*.[1776] Leased property, accordingly, is included in the factor's scope of application. Intangible assets and monetary assets are typically excluded. A similar approach can be found in the CCCTB Proposal, which limits the asset factor *to "all fixed tangible assets owned, rented or leased"*,[1777] thereby even excluding inventories.[1778] The Canadian formulary system does not even use capital as an allocation factor in the first place because of the practical problems its use would raise.[1779]

The exclusion of non-physical assets from the asset factor is generally explained by reference to the practical problems and arbitrage issues that their inclusion would produce.[1780] These arise as a consequence of their intangible, volatile, and mobile properties. *"[A]s long as the apportionment mechanism relies on mobile factors under the control of the company, FA creates incentives for firms to shift factors across countries to minimize the groups' overall tax burden and thereby it may give rise to certain tax competition by governments to attract real economic activity into their territories, which may create some economic distortions."*[1781] Issues particularly arise with regards to high-worth intellectual property rights. These

[1775] See on the value gap in commercial accounting relating to intellectual property and intangible assets, Gordon V. Smith et al, *Valuation of Intellectual Property and Intangible Assets (2000)*.
[1776] See Article IV(10) Multistate Tax Compact.
[1777] See Article 92(1) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).
[1778] The Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 9 (par. 31), argues the inclusion of inventories to produce profit shifting opportunities. See also Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 276: *"if inventory is included in the property factor, the taxpayer can shift some portion of its income out of the production state by shipping its inventory outside that state."* Mayer on the other hand argues that the exclusion of inventories would not be necessary as their relocation would represent a shift of real economic activities. See Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 211.
[1779] See Joann M. Weiner, 'Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level', 13 *Tax Notes International* 2113 (23 December 1996), at 2130 et seq, and Ernest H. Smith, 'Allocating to Provinces the Taxable Income of Corporations: How the Federal-Provincial Allocation Rules Evolved', 24 *Canadian Tax Journal* 5 (1976), at 551.
[1780] See e.g., the Preamble to the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS), observation 21: *"Intangibles and financial assets should be excluded from the formula due to their mobile nature and the risks of circumventing the system"*. See also Christoph Spengel et al, 'The Impact of ICT on Profit Allocation within Multinational Groups: Arm's Length Pricing or Formula Apportionment?', *ZEW Discussion Paper* 2003:53, at 23.
[1781] See Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 9-10 (par. 22).

intangibles often are the multinational's key rent drivers and are therefore of great commercial value to the firm.[1782] However, because of that reality in combination with the mobile and intangible characteristics of these assets, any attribution key seeking to evaluate and geographically locate intangibles for tax allocation purposes would be vulnerable and subject to manipulation. In the end, the inclusion of intangible assets in a formulary system seems to give rise to problems identical to those in transfer pricing.[1783]

However, their exclusion from the asset factor has also attracted some criticism.[1784] *"[T]o omit intangible assets from a potential EU formula altogether seems highly unsatisfactory (…). It would mean ignoring one of the potentially most important profit-generating factors, it would generally result in a misattribution of the group tax base (with an unduly low share going to jurisdictions where the corporation develops or holds more intangibles) - unless tangible and intangible assets are evenly distributed across all the group affiliates, which is highly unlikely – and it could distort corporate groups' choices between tangible and intangible assets (when they were substitutes), thus rendering the tax system non-neutral and creating inefficiencies."*[1785]

Nevertheless, the exclusion of intangibles from the asset factor does not mean that their contributions to income are disregarded in the profit division process. If intangibles are not expressly dealt with in the formula allocation, they piggyback on the profit division in proportion to the factors that are expressly dealt with (e.g., payroll, sales). The effect is conceptually similar to the application of a throw-out rule discussed in the above. Some commentators argue that such an indirect reflection of intangibles in the formula sufficiently accounts for their contribution to the generation of corporate profit. That is, as the profits from the commercialization of intangibles are reflected in the receipts on services and goods provided to third parties and the salaries paid to the workers that use the intangibles in the business process when they exercise their employment contracts.[1786] Others disagree, however.[1787] The CCCTB Proposal takes a middle way and seeks to resolve things pragmatically. In some circumstances the asset factor includes *"the total amount of costs incurred for research, development, marketing and advertising"*. Specifically: *"In the five years that follow a taxpayer's entry into an existing or new group, its asset factor shall also include*

[1782] See e.g., Gordon V. Smith et al, *Valuation of Intellectual Property and Intangible Assets (2000)*, Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 7 (par. 16), and Yariv Brauner, 'Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes', 28 *Virginia Tax Review* 81 (2008).

[1783] Cf. Charles E. McLure Jr., 'Replacing Separate Accounting and the Arm's Length Principle with Formulary Apportionment', 56 *Bulletin for international taxation* 586 (2002), at 595, Charles E. McLure, Jr., 'U.S. Federal Use of Formula Apportionment to Tax Income From Intangibles', 14 *Tax Notes International* 859 (10 March 1997), at 866, and Paul R. McDaniel, 'Formulary Taxation in the North American Free Trade Zone', 49 Tax Law Review 691 (1993-1994), at 722 et seq.

[1784] See e.g., Christoph Spengel et al, 'The Impact of ICT on Profit Allocation within Multinational Groups: Arm's Length Pricing or Formula Apportionment?', *ZEW Discussion Paper* 2003:53, at 23, and Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 225. See for a comparison, Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 52, *An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB*, Taxud E1 AAG-GR-FF, CCCTB\WP\052\doc\en, Brussels, 27 February 2007, at 8 (par. 37): *"The prevailing opinion was that intangible assets should be taken into account in a formula, although this raises important questions of valuation (especially for selfgenerated intangibles and intangibles that do not generate a stream of income) and of location (which company should account for the intangible, the company using it or the company receiving the royalty payment for granting the use of it?)".*

[1785] See Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 51.

[1786] See e.g., Jerome R. Hellerstein, 'Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment', 60 *Tax Notes* 1131 (23 August 1993), 1136-1145, at 1141, and Benjamin F. Miller, 'A Reply to 'From the Frying Pan to the Fire', 61 *Tax Notes* 241 (11 October 1993), at 251.

[1787] See e.g., Charles E. McLure, Jr., 'U.S. Federal Use of Formula Apportionment to Tax Income From Intangibles', 14 *Tax Notes International* 859 (10 March 1997), at 865 (footnote 25), where he sets forth to disagree with the view *"that it is not necessary to include intangibles in the property factor because their effect is adequately captured by the sales and payroll factors. Most obviously, the sales factor would not capture the transfer of intangibles within a unitary business; it would ignore them. The contribution of the sales factor would be the same (assuming the same ratio of numerator and denominator in the sales factor), regardless of the importance of intangibles and regardless of whether their value is based on R&D or on reputation. The issue at hand is whether the intangible asset should be attributed (at least in part) to the market country for purposes of the property factor."* See also Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 225-228.

the total amount of [these] costs incurred by the taxpayer over the six years that preceded its entry into the group."[1788]

Valuation. The asset factor seeks to address the remunerations that the firm pays in return for utilizing its assets in the business process. The factor accordingly is generally evaluated by reference to the original costs of the property involved.[1789] With regards to depreciable assets, that amount would need to be adjusted by depreciation according to the accounting rules or the tax rules in that area.[1790] Leased or rented assets are typically measured by reference to the capitalized rental fees.[1791]

Various commentators have argued that the assets in the factor should be evaluated by reference to fair market value instead of costs.[1792] That is, first, since cost – as elaborated in the above – do not explain profits. Further, second, the use of a cost-based profit division approach has the effect of attributing profit to taxing jurisdictions where the costs are higher, while costs in fact reduce profit.[1793] That would accordingly seem to produce outcomes where cost-inefficient operations would be rewarded a relatively higher profit. Interestingly, conceptually similar concerns have been raised by some commentators with regards to the application of the cost-based transfer pricing methods.[1794] In response to that, it has been forwarded that this does not seem to have raised concerns in US state income tax practice regardless, and moreover, basically that cost level differentials are the result of market inefficiencies – i.e., an issue like wage level differentials being analytically separate from taxation and are therefore not to be 'corrected' through a tax base allocation system.[1795]

[1788] See for some discussion, Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 231. Hellerstein sets forth that *"[i]t is not entirely clear why this aspect of the factor evaporates after five years. Presumably, the theory is that whatever contribution these costs made to the taxpayer's income has a useful life of only five years. This leaves open the question, of course, as to why costs incurred during the taxpayer's membership in the group are not also counted. The answer, presumably, is that it would be easy to lodge these costs in a group member from a low-tax Member State. This disparity in treatment of 'intangible' costs is just another example of the tension between theoretical and practical concerns that informs the design of the CCCTB sharing mechanism."*

[1789] See e.g., Article 94 Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS), and Article IV(11) Multistate Tax Compact. The US system uses historical cost. Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), notes at 212 that this aspect is criticized as it tends to *"overvalue the contributions of long-lived assets and undervalues those of short-lived ones."* Mayer refers for this purpose to Charles E. McLure Jr., 'Replacing Separate Accounting and the Arm's Length Principle with Formulary Apportionment', 56 *Bulletin for international taxation* 586 (2002), at 594.

[1790] See e.g., Article 94(2)-(3) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS), which refers to the tax written down value. See Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, which has suggested this at 10 (par. 36). Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, mentions at 49 that the written-down value could be indexed by a rate of inflation to avoid comparability issues between assets that had been acquired at different times. Both the US system and the CCCTB do not make such an inflation adjustment. For some critique, see Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 211.

[1791] See Article IV(11) Multistate Tax Compact: *"Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals."* Article 94(4) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS) takes the same approach.

[1792] See, e.g. Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 211: *"[T]he cost of assets provides a poor approximation of both their value and the use cost of capital,"* Charles E. McLure, Jr., 'U.S. Federal Use of Formula Apportionment to Tax Income From Intangibles', 14 *Tax Notes International* 859 (10 March 1997), at 866, Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 285, Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 49, Christoph Spengel et al, 'The Impact of ICT on Profit Allocation within Multinational Groups: Arm's Length Pricing or Formula Apportionment?', *ZEW Discussion Paper* 2003:53, at 23.

[1793] See Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 209.

[1794] Notably, J.T. van Egdom RA, *Verrekenprijzen; de verdeling van de winst van een multinational* (2011), at 82, argues that it would therefore seem to make sense to establish the arm's length mark-up on budgeted costs.

[1795] Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 213.

It should be kept in mind that the objective of formulary systems is to approximate the location of corporate profit, amongst others, by reference to the remunerations paid to obtain the assets utilized in the business process. It makes use of a cost-based approach as a proxy to evaluate the attribution of property to profit generation. Formulary systems, as said, do not aim at localizing *the* profit. Furthermore, the pursuit of fair value for evaluation purposes in formulary apportionment would raise the same issues that the international tax regime is currently faced with under its use of SA/ALS, particularly where it involves the valuation of intangibles.[1796] The fair value of the respective assets would also in formulary apportionment be measured by reference to today's worth of anticipated future rents, calculated by reference to discounted cash flow evaluations or sophisticated Black-and-Scholes real option based valuation techniques. As these techniques require the assessment of anticipated future cash-flows, their use in formulary systems would produce the same issues as they currently do in transfer pricing (see above sections 6.3.4.4 and 6.3.4.5). The concerns raised, indeed, are identical – and, in my view, insurmountable. Firm inputs cannot be evaluated objectively at the end of the day.

Location. As the asset factor seeks to reflect the contribution of the firm's debits in the origin state, the factor should geographically localize the assets involved where these are actually utilized by the firm's workers in the firm's production process.[1797] The factor should accordingly aim to identify the locations of functional utilization, i.e., the locations of the 'functions performed'. The typical starting points in practice are the place of use[1798] or the location of the economic owner.[1799] To the extent that property is mobile, or in-transit, and used in or shipped across various jurisdictions, some kind of attribution needs to be undertaken. Perhaps one may consider matching the costs involved with the locations in which the assets are situated by reference to some causality key. For administrative convenience reasons, however, I would favor doing this alternatively. I would advocate adopting a fractional approach, which refers to the respective assets' days of use within the taxing jurisdictions involved during the respective taxable period in the numerator, and the total number of days of use in that period in the denominator, i.e., a 'time spent test' comparable with the 'working days test' set out in the above.[1800] Some adaptations could be contemplated with regards to property in international waters, and property that is temporarily not in use. That is, if one were to consider using a property factor in the first place.

This would boil down to the following nexus/allocation asset factor: '$\text{assets State A} = \text{assets costs} * \frac{\text{asset utilization period(s) by workers in State A}}{\text{overall asset utilization period(s)}}$'.[1801] For administrative convenience reasons, incidental asset utilization by the firm's workers in a certain tax jurisdiction could be disregarded under a *de minimis* nexus threshold rule. Such a rule could be defined, for

[1796] Cf. Charles E. McLure Jr., 'Replacing Separate Accounting and the Arm's Length Principle with Formulary Apportionment', 56 *Bulletin for international taxation* 586 (2002), at 595, Charles E. McLure, Jr., 'U.S. Federal Use of Formula Apportionment to Tax Income From Intangibles', 14 *Tax Notes International* 859 (10 March 1997), at 866, and Paul R. McDaniel, 'Formulary Taxation in the North American Free Trade Zone', 49 Tax Law Review 691 (1993-1994), at 722 et seq.

[1797] Cf. Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 11 (par. 39), referring to the 'place of effective use'.

[1798] Article IV(10) Multistate Tax Compact, for instance, refers to *"property (…) used in this State."* Article 93(2) CCCTB Proposal assigns to the user, save for the meeting of certain reassignment thresholds: *"Notwithstanding paragraph 1, if an asset is not effectively used by its economic owner, the asset shall be included in the factor of the group member that effectively uses the asset. However, this rule shall only apply to assets that represent more than 5% of the value for tax purposes of all fixed tangible assets of the group member that effectively uses the asset."*

[1799] See Article 93(1) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS): *"An asset shall be included in the asset factor of its economic owner. If the economic owner cannot be identified, the asset shall be included in the asset factor of the legal owner."* With regards to leased or rented assets, paragraph 3 forwards that these *"shall be included in the asset factor of the group member which is the lessor or the lessee; [t]he same shall apply to rented assets."*

[1800] See for a comparison Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, notes at 21. Weiner mentions that such a rule which refers to the share of total time spent in the state during the tax period.

[1801] Please note that to the extent the application of the fraction involves an asset that is utilized solely within a single state, the application of the fraction with regard to that asset would be 1.

instance, as 'nexus if asset(s) state A exceeds amount $, ¥, or €x' (e.g., $, ¥, or €50,000),[1802] or 'nexus, alternatively, if the aggregate formula attributes more than x% of profits' (e.g., 25%) – i.e., the latter would apply if the first mentioned nexus standard has not been met.[1803] Notably, the currency used would differentiate per taxing state – currency issues are discussed hereunder. Accordingly, the labor test and asset factor test would correspond.

Please note that the issues involving the localization of the asset factor again is not indigenous to formulary apportionment. Actually, matters are conceptually identical to the issues that arise in geographically localizing assets in international taxation when analyzing the functions performed (labor), the assets used (capital) and risks assumed.[1804] Indeed, the approach echoes the concept of 'significant people functions' assessing the 'functions performed' in the area of transfer pricing, i.e., the approach taken (1) to attribute profit to permanent establishments under the first step of the 'two-step analysis', (2) to perform the 'functional and factual analysis' as one of the 'comparability factors' under the 'comparability analysis', and (3) to perform the 'contribution analysis' c.q. the 'residual analysis' to localize firm inputs under the application of the '(residual) profit split method' – generally referred to under the term 'functions performed'. Indeed, the concept of 'significant people functions', as said earlier, provides for a nexus concept that is oriented most directly towards identifying the location of the employed production factors. We seem to have moved in a circle, from transfer pricing to formulary apportionment and back to transfer pricing; it has not been a coincidence that section 6.3.3.4 has called for a factor presence test.

It follows that the same holds true for the localization of intangibles under the asset factor – i.e., if these are to be included in the apportionment system. Intangible assets such as intellectual property do not have a geographic location by definition. In addition, multinational firms may (and typically do) utilize their intellectual property rights, such as their trademarks, brands, trade names and patents in their business process simultaneously at various places, regionally and perhaps even globally.

Would it be possible to even develop an approach to properly divide the intangibles' values (or costs by proxy) among the 'significant people', i.e., the firm's workers of the multinational firm? Which key should be used? Localizing intangibles proportional to the numbers of employees? Or alternatively, by reference to wages paid? The first approach would end up attributing the (costs of) intangibles in proportion to employee numbers – i.e., some kind of 'headcount allocation', or 'fte allocation'. The second would produce a geographic localization of intangibles in proportion to the wages paid. That approach would basically end up producing payroll-FA, as the intangibles would effectively end-up piggybacking the payroll factor. Interestingly, in that event, the inclusion of intangibles into the formulary system would then basically produce the same outcome in terms of geographic profit division as its exclusion from the system would.

So, would it be sensible to even try to pursue, in Langbein's words, the *"pointless task of localizing the non-localizable"*?[1805] Since profit does not have geographical attributes and neither do intangibles, my answer to this question would be in the negative. Moreover, bringing into mind that firm rents are currently increasingly firm specific rather than location specific,[1806] perhaps it merits some consideration to exclude an asset factor from the system altogether.

[1802] That would for instance cancel out short-term low-value asset utilization in a taxing jurisdiction from the equation.
[1803] Cf. Multistate Tax Commission, *Federalism at Risk, A Report of the Multistate Tax Commission*, June 2003, at Appendix D.
[1804] See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Centre for Tax Policy and Administration, *2010 Report on the Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010, and 26 CFR 1.482-1(d)(3)(i) in conjunction with 26 CFR 1.482-1(d)(3)(iii).
[1805] See Stanley I. Langbein, 'The Unitary Method and the Myth of Arm's Length', 30 *Tax Notes* 625 (17 February 1986) at 670. See also Lawrence Lokken, 'The Sources of Income From International Use and Dispositions of Intellectual Property', 36 *Tax Law Review* 233 (1980-1981), who argues at 244 that there is no objective method for dividing a gain on sale of intellectual property between the production and selling functions.
[1806] Cf. Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008).

As firm inputs cannot be objectively measured, the firm's 'crown jewels' cannot even be located, perhaps it may be worth merely considering payroll to reflect inputs at origin. That is, provided that one would opt to divide profit by reference to firm inputs in the first place. In the end, fundamentally, the origin of income refers to the human intervention or intellectual element, recognizing that income originates where people actually perform economic activities. People produce income; equipment and legal constructs do not do so by themselves. The assets that are being employed in the business process merely provide means, or instruments, to enhance workforce productivity.

But for firm input assignment purposes, these would end up being evaluated by reference to labor cost. Yet, it has been done in practice. At this point the Canadian system may be recalled, which divides profit interprovincially by reference to an equally weighted payroll-sales formula. Assets are disregarded as an origin-based apportionment factor, only payroll is employed for that purpose. The German 'Gewerbesteuer', for instance, operates a payroll-only formulary system.[1807] That is a fully-fledged origin-based apportioning system solely making reference to labor inputs, ignoring not only capital but also the destination municipality for trade tax division purposes.

Intermezzo; the 'value added key at origin': the suggested but ill-featured alternative

Notably, before proceeding to the sales factor, the following should be noted. It has been suggested in the literature to take together the contributions of the production factors of labor and capital and combine them into a single apportionment factor for profit division purposes.[1808] That would produce an origin-based profit division methodology on the basis of which the return to labor component and the return to capital component would be accounted for 'by their relative importance in the generation of profit'.[1809] The approach has been referred to in the literature as 'value added at origin'. It would provide for an alternative to traditional formulary apportionment. It only exists on the drawing board and has not been used in practice. But with regards to the CCCTB project, the European Commission did look into the possibility of attributing profit geographically by reference to such a value added key at origin.[1810]

The value added at origin approach basically seeks to evaluate and localize the fair value of firm inputs, both labor and property in the production state. As discussed, in my view, this would be very difficult if not impossible to achieve, as, first, it would require the assessment of anticipated future cash-flows. Second, it would require a geographic localization of intangibles, a localization of the non-localizable. Furthermore, as the approach would provide for an origin-based attribution key, the production state would need to take into account the outbound flows of goods and services produced, including the intra-group provisions and flows of goods and services. That would consequently require an arm's length evaluation of intra-group dealings.

Accordingly, the use of a value added at origin key would reintroduce transfer pricing and with that the problems and arbitrage its use ensues. This transfer pricing property of the suggested methodology has been referred to in the literature as its 'Achilles' heel'.[1811] If it would be

[1807] See § 29 (Zerlegungsmaßstab) in conjunction with § 31 (Begriff der Arbeitslöhne für die Zerlegung) of the German Trade Tax Act (Gewerbesteuergesetz, GewStG).
[1808] See Sven-Olof Lodin et al, *Home State Taxation - Tax Treaty Aspects* (2001), at 47-50. For an extensive discussion, see Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 69-85.
[1809] See Charles E. McLure Jr., 'Replacing Separate Accounting and the Arm's Length Principle with Formulary Apportionment', 56 *Bulletin for international taxation* 586 (2002), at 593, and Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 48.
[1810] See Commission of the European Communities, Commission Staff Working Paper, *Company Taxation in the Internal Market*, Brussels, 23 October 2001, SEC(2001) 1681, at 414.
[1811] Cf. Charles McLure, Jr., 'The European Commission's Proposals for Corporate Tax Harmonization', 6 *CESifo Forum* 32 (2005), at 36, and Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 49, both referring to Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance*

feasible to properly appraise the relative contribution of functions performed in transfer pricing, the international tax regime would not be in need of an alternative profit division methodology. Value added at origin accordingly seems an ill-featured attribution key, and its use, in my view, should therefore not be pursued. Also, the CCCTB Working Group considers the method inappropriate for sharing the CCCTB.[1812]

Sales factor: sales and services contributing to rent production, gross receipts, location of customer

Scope. The sales factor seeks to reflect the contribution of the demand side to the generation of the firm's rents, or the firm's market for its product. Its scope should accordingly cover the goods and services the firm provides to its customers.[1813] Intra-group sales should be disregarded.[1814] Principally, the factor would need to include all the goods and the services that the firm supplies in the course of its business[1815] – in my view, sales of intermediate or goods,[1816] occasional sales, incidental sales, and the sales of direct investments included.[1817]

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199 (2004), 199-220, at section 4.4. See also Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 82.

[1812] See Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 52, *An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB*, Taxud E1 AAG-GR-FF, CCCTB\WP\052\doc\en, Brussels, 27 February 2007, at 4-5 (par. 14-20).

[1813] See for a comparison, Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 285: *"The revenue factor would include all of the receipts derived by the common enterprise from the marketing of its goods and services."* Notably, in defining 'sales', Article IV.1(g) MTC effectively refers to the transactions that are related to the taxpayer's business income. See Multistate Tax Commission, *Multistate Tax Compact Article IV - Recommended Amendments*, 3 May 2012, at 14.

[1814] See Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 53: *"Logically, intra-group sales should be excluded from (…) this factor, as only third-party unrelated sales have contributed to the net group profits that the factor seeks to apportion."* See also Article 95(2), final phrase, CCCTB Proposal: *"Intra-group sales of goods and supplies of services shall not be included."* Cf. Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, which refers to throwback rules at 7-8 (par. 17), Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 52, *An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB*, Taxud E1 AAG-GR-FF, CCCTB\WP\052\doc\en, Brussels, 27 February 2007, at 9 (par. 40), and Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 12 (par. 44).

[1815] See e.g., MTC Reg. IV.15.(a) which refers to *"transactions and activity in the regular course of the trade or business,"* Multistate Tax Commission, *Allocation and Apportionment Regulations*, Adopted February 21, 1973; as revised through July 29, 2010, at 31. See also Sec. 402(5) Canadian Income Tax Regulations, which does not include in the gross receipts factor *"interest on bonds, debentures or mortgages, dividends on shares of capital stock, or rentals or royalties from property that is not used in connection with the principal business operations of the corporation."*

[1816] Indeed, I would also take sales of semi-finished into account. That is as the sales factor in my view seeks to identify the customer rather than the final consumer – as for instance European Union value added taxation ('EU-VAT') does. Accordingly, issues involving chain transactions or other kinds of series of supplies over various phases in the production-distribution chain similar to those in EU-VAT would not arise (i.e., those involving 'ABC-supplies', or 'Reihengeschäfte'). Further, 'tax cascading' issues would not arise also as the system that is advocated in this study taxes rents rather than gross value added. See on the apparent tax cascading risks under the sales factor, Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 54. It should be kept in mind that the system that is advocated in this study seeks to subject rents to corporate taxation. The geographical division of these rents under a destination-based sales factor does not alter matters analytically, i.e., because the sales factor merely apportions tax base rather than defining it. Since the advocated system subjects rents to tax – not gross proceeds, or value added like EU-VAT – tax cascading issues would not when intermediate sales are included in the sales factor.

[1817] See e.g., Charles E. McLure Jr., 'Replacing Separate Accounting and the Arm's Length Principle with Formulary Apportionment', 56 *Bulletin for international taxation* 586 (2002), at 596: *"The fact that investment income is included in apportionable income suggests that investment receipts should be treated like other receipts."* Contra MTC Reg. IV.18.(c) *"Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, those gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded"*, Multistate Tax Commission, *Allocation and Apportionment Regulations*, Adopted February 21, 1973; as revised through July 29, 2010, at 39.

The sales factor would include both business-to-consumer transactions ('B2C transactions') and business-to-business transactions ('B2B transactions').[1818]

Only the sales that contribute to the production of the firm's economic rents should be included in the sales factor's scope of application.[1819] The firm's positions in respect of their sales and services that do not contribute to the infra-marginal profit-making should be disregarded. That would hold true, first, for the shareholdings to which the 'indirect tax exemption' would apply, i.e., the double tax relief mechanism that has been developed and advocated in Chapter 5 to mitigate the tax cascading (economic double taxation) relating to the proceeds from actively held shareholdings. Participations to which the exemption would apply should be excluded from the sales factor.[1820] Second, the firm's hedging activities would be excluded from the sales factor also, i.e., as their selling effectively does not produce corporate profit.[1821] The same would hold true, third, for the firm's portfolio investment activities.[1822] *"If the purpose of the sales factor is to reflect the taxpayer's market for its product, then, unless the taxpayer is a securities dealer, receipts from its treasury function and other financial activities should be excluded."*[1823] Further, an additional argument to exclude portfolio investments from the sales factor is that these positions do not produce rents. Portfolio investments merely generate normal returns, rather than above-normal returns. And, as discussed in Chapter 5, my aim is to tax that above normal return (i.e., to secure neutrality in the financing decision).

Further, it would also ensure that artificialities and arbitrage would not leak into the formulary system. Sales factor manipulation and sales factor inflation opportunities like those described in the above involving 'beneficiary group members' under the proposed CCCTB and the

[1818] Note that I adhere to European Union value added taxation ('EU-VAT') language by differentiating between B2B and B2C sales.

[1819] See for a comparison, Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 238: *"[T]he US subnational state sales factors … defined 'gross receipts' … that they had to generate apportionable income."*

[1820] See for a comparison Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38, where the author argues not to include tax exempt proceeds from participations in the CCCTB's sales factor on the basis that these do not contribute to the CCCTB group's profit making. See also Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 217, as well as Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 13 (par. 50), both arguing that base exempt proceeds should be excluded from the sales factor's scope of application.

[1821] Cf. Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38. Reference can also be made to Cal. Rev. & Tax Code § 25120(f)(2)(L) , on the basis of which the California state income tax legislature for similar reasons excludes amounts received from hedging transactions from the sales factor per 1 January 2011. The references to California legislation has been taken from Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 240.

[1822] See e.g. Multistate Tax Commission, *Multistate Tax Compact Article IV - Recommended Amendments*, 3 May 2012, at 15, referring to the excluding from the sales factor, the *"receipts of a taxpayer other than a securities dealer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities."* See for a comparison also MTC Reg. IV.18.(c).(3)): *"For example, where business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, the dividends and interest shall be excluded from the denominator of the sales factor,"* Multistate Tax Commission, *Allocation and Apportionment Regulations*, Adopted February 21, 1973; as revised through July 29, 2010, at 40.

[1823] See Multistate Tax Commission, *Multistate Tax Compact Article IV - Recommended Amendments*, 3 May 2012, at16. See also Sec. 402(5) Canadian Income Tax Regulations, which does not include in the gross receipts factor *"interest on bonds, debentures or mortgages, dividends on shares of capital stock, or rentals or royalties from property that is not used in connection with the principal business operations of the corporation."* And see also Sec. 402(5) Canadian Income Tax Regulations, which does not include in the gross receipts factor *"interest on bonds, debentures or mortgages, dividends on shares of capital stock, or rentals or royalties from property that is not used in connection with the principal business operations of the corporation."* See for a comparison also Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 56, *Report and overview of the main issues that emerged during the discussion on the sharing mechanism SG6 second meeting – 11 June 2007*, Taxud E1 OP, CCCTB\WP\056\doc\en, Brussels, 20 August 2007, at 8 (par. 28): *"The view of two of the experts was that financial revenues such as dividends or interests received should not be included in the sales factor,"* and Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 13 (par. 50): *"Revenues from passive income such as interest, dividends, deemed dividends and royalty should not be included, either - unless it represents the revenues accrued in the ordinary course of trade or business (the core business)."*

equivalent planning opportunities in US state income taxation would not arise. As the performance of shareholding management functions, treasury functions, cash-pooling functions, and the management of hedging positions would be excluded from the sales factor, these activities would not affect the profit attribution process. Hence, these also could not be utilized for sales factor manipulation purposes.

Valuation. The sales factor seeks to address the remunerations that the firm receives in return for the goods and services that it provides. Accordingly, the factor addresses revenue or gross receipts. That would include all receipts from the sales of goods, as well as the receipts from the provisions of services, including rentals and royalties, to the extent that these services are supplied in the course of the firm's active business operations. Some commentators therefore refer to this factor as the 'gross receipts factor',[1824] the 'revenue factor',[1825] or the 'gross revenue factor'.[1826] Others use the terms 'gross receipts factor' and 'sales factor' synonymously.[1827] Since many of the American states refer to it as the 'sales factor' and so does the CCCTB proposal, I will do the same and make use of the term 'sales factor' also. This merely is for the sake of convenience as I consider the terms basically synonyms in substance.[1828]

Regardless of the terminology used, it should be noted that the sales factor typically does, and in my view also should, refer to the gross amounts that the firm receives from its customers for the product provided. Note that receipts from actively held exempt shareholdings (dividends, capital gains) would be excluded from the sales factor for the reasons set forth in the preceding paragraphs. The same would hold true for the receipts from the holding of financial instruments and passively held portfolio investments (hedging proceeds, dividends receipts, interests, received lease and licensing payments, et cetera).[1829-1830]

In my view, no adjustment should be made for costs incurred, such as overhead costs and costs to sales. It should be kept in mind that the objective of formulary systems is to approximate the location of corporate profit, amongst others, by reference to the remunerations that the firm receives in return for the product provided, i.e., its outputs. Formulary systems make use of a revenue-based approach as a proxy to evaluate the attribution of sales to profit generation. Taking into account costs incurred in evaluating the sales factor would effectively introduce firm inputs into the evaluation of the factor. Such a 'net outputs approach' would produce a somewhat confused outcome, double counting firm inputs

[1824] See Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 52 et seq.

[1825] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 285, et seq., e.g. at 285: *"The term "revenue" factor is used here to make clear that certain receipts, such as repayments of a loan, are not included in the factor but that the factor is substantially broader than the term "sales factor" would suggest"*.

[1826] In Canada, reference is made to the 'gross revenue factor'. See Sec. 402(4) and (5) Canadian Income Tax Regulations. Cf. Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 117-118.

[1827] See Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 22. Weiner refers to UDITPA which defines 'sales' as 'gross receipts'.

[1828] See for a comparison Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 285: *"Many of the American states refer to this factor as the "sales" factor because the most common items included in the factor are the proceeds from sales. Some states use the term "receipts" factor to signal that amounts received as lease payments, royalties, payments for services, and such are also included in the factor."*

[1829] It is noted that some American states, e.g., California, adopt a net-approach with respect to the proceeds the selling of short-term portfolio investments through the performing of a treasury function. See Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 237-241, making reference to a California state income tax case in which the court required the taxpayer to apply the sales factor on a net basis in this respect. Hellerstein refers to *Microsoft Corp. v. Franchise Tax Board*, 39 Cal. 4th 750, 139 P.3d 1169, 47 Cal. Rptr. 3d 216 (2006).

[1830] Rather than applying a net-approach the Uniformity Committee Multistate Tax Commission considers the exclusion the better approach. See Multistate Tax Commission, *Multistate Tax Compact Article IV - Recommended Amendments*, 3 May 2012, at 16: *"Some states exclude these receipts entirely. Some limit inclusion to net rather than gross receipts. If the problem were only distortion, then a limitation to net may be fine. But if there is also a policy problem of inconsistency with the purpose of the sales factor, or a practical problem of how to source these treasury function receipts, then exclusion may be the better approach. The Committee chose exclusion."*

as these would also be recognized under the input factors. Furthermore, the pursuit of a net value added approach would require a geographic costs allocation. That would trigger intricate issues similar to those in transfer pricing – see further the upcoming paragraphs under the header '*Intermezzo; the 'value added key at destination': an ill-featured alternative indeed*'.[1831]

Location. The sales factor seeks to reflect the contribution of demand to income-production. Accordingly, it should geographically aim at approximating the sales involved at the location where these are utilized or consumed by the customer, i.e., the destination jurisdiction. With regards to B2B-sales, the factor would need to be assigned geographically to the location where the customer makes use of the goods and services that were provided to it in its business process.[1832] Regarding B2C-sales, the factor would need to be assigned to the place of final consumption. The approach taken in this respect, accordingly, not only echoes the approach taken in the US.[1833] and Canadian[1834] formulary systems, and the CCCTB sharing mechanism,[1835] but also that in European Union value added taxation,[1836] and the US[1837] and Canadian[1838] sales tax systems.

A great diversity of keys is referred to in practice and in the literature to localize the firm's customer. However, many do not reflect the destination jurisdiction at all, but, rather make use of origin based allocation keys.

First, many place of sales rules effectively assign the sales factor to the origin jurisdiction rather than the destination state. Examples are:

- the 'place of the performance of the income-producing activities' regarding the provision of services (US);[1839]
- the 'place of the performance of the income-producing activities' by reference to the 'costs of performance', i.e., if these activities are carried out in more than one taxing jurisdiction (US);[1840]
- the place of the customer location, yet, provided that the goods seller operates a permanent establishment at that place (Canada);[1841]

[1831] Cf. Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), 199-220, at 216.
[1832] Cf. Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38.
[1833] See, for instance, Article IV.16(a) Multistate Tax Compact, which sets forth the basic rule assigning sales to the location of the purchaser.
[1834] Sec. 402(4) Canadian Income Tax Regulations.
[1835] See Article 96(1) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).
[1836] See Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax ('EU-VAT'). EU-VAT seeks to locate the tax at the place of final consumption. For discussion and analysis, see European Commission, Green Paper; *On the future of VAT – Towards a simpler, more robust and efficient VAT system*, COM(2010) 695 final, Brussels, 1 December 2010, and Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the future of VAT; *Towards a simpler, more robust and efficient VAT system tailored to the single market*, COM(2011) 851 final, Brussels, 6 December 2011.
[1837] On the US sales and use tax system, see Neal A. Koskella, 'The Enigma of Sales Taxation Through the Use of State or Federal "Amazon" Laws: Are We Getting Anywhere?', 49 *Idaho Law Review* 121 (2012), at 124 et seq.
[1838] See Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 118. *"Generally, the gross revenue factor measures sales at destination, in line with the Canadian retail sales tax system."*
[1839] See Article IV.17(a) Multistate Tax Compact: *"Sales, other than sales of tangible personal property, are in this State if (a) the income-producing activity is performed in this State."* Charles E. McLure, Jr., 'Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment', 56 *Bulletin for international taxation* 568 (2002), criticizes the 'place of performance rule' at 595 as being inconsistent with the destination principle.
[1840] See Article IV.17(b) Multistate Tax Compact: *"Sales, other than sales of tangible personal property, are in this State if (b) the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance."* Warren refers to the using of the ''all or none'' aspect of the 'cost of performance rule' arbitrary. See John S. Warren, 'UDITPA – A Historical Perspective', 38 *State Tax Notes* 133 (3 October 2005), at 135.
[1841] See Sec. 402(4)(a) Canadian Income Tax Regulations: *"For the purpose of determining the gross revenue for the year reasonably attributable to a permanent establishment in a province or country other than Canada, (…) the following rules shall apply: (a) where the destination of a shipment of merchandise to a customer to whom the merchandise is sold is in the particular province or country, the gross revenue derived therefrom shall be attributable*

- the place of services rendered, yet, provided that the service provider operates a permanent establishment at that place (Canada);[1842]
- the 'group member in the Member State where the services are physically carried out' (CCCTB);[1843]
- the 'group member located in the Member State where dispatch or transport of the goods to the person acquiring them ends' (CCCTB);[1844]
- the vendor's site of establishment.[1845]

Second, the various throw-back rules effectively assign sales to the origin state as well.[1846] This holds up for those used in the US and Canada, as well as the CCCTB sharing mechanism. The throw-back rule in the US Multistate Tax Compact for sales of tangible goods, for instance, reapportions the sales of goods to the location from which these have been shipped, i.e., if the general rule would assign these sales to the customer location while the seller lacks a taxable presence there.[1847] The Canadian rules reassign gross receipts from supplies of goods and services in equivalent cases to the location of the corporation's permanent establishment where the person attached to that establishment negotiated the contract.[1848] The CCCTB's 'spread throw-back rule' reassigns the 'sales to all the group members in proportion to their labor and asset factors,' i.e., 'if there is no group member in the Member State where goods are delivered or services are carried out, or if goods are delivered or services are carried out in a third country.'[1849]

The use of such origin-oriented factor assignment rules is incoherent with the basic conception of allocating the sales factor to the destination state. This produces outcomes inconsistent with the understanding of attributing sales to the market jurisdiction. Further, it is conceptually unnecessary to make use of throw-back rules.[1850] 'Nowhere income' issues can alternatively be resolved by coordinating nexus and apportionment standards by reference to factor presence tests.

Fortunately, though, there are also various allocation keys available which do seek to assign the receipts to the destination jurisdiction. Examples are:

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to the permanent establishment in the province or country." The requirement of having a permanent establishment present transforms the initial destination basis allocation key effectively into an origin key.

[1842] See Sec. 402(4)(g) Canadian Income Tax Regulations: *"where gross revenue is derived from services rendered in the particular province or country, the gross revenue shall be attributable to the permanent establishment in the province or country."* Again, the requirement of having a permanent establishment present transforms the initial destination basis allocation key effectively into an origin key.

[1843] See Article 96(2) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS): *"Supplies of services shall be included in the sales factor of the group member located in the Member State where the services are physically carried out."* Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 229, is critical on the use such a 'place of performance rule' in the CCCTB Proposal: *"Although the place where services are physically carried out may well reflect their destination, in many situations, particularly with respect to so-called 'intangible services, this often will not be the case."* In addition, the assigning to the location of the group member effectively transforms the key into an origin key; basically in a manner similar as the Canadian system does.

[1844] Article 96(1) CCCTB Proposal. The location of that group member may well reflect the customer location and with that the destination of the sale, this however is not necessarily the case. Again, the assigning to the location of the group member effectively transforms the key into an origin key; again, like the Canadian system does.

[1845] Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 53. Garcia also mentions the place of establishment of the internet service provider. As this would entail the establishing of a taxable presence of a third-party, I do not think that such an approach merits consideration.

[1846] Cf. Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 212.

[1847] See Article IV.16(b) Multistate Tax Compact.

[1848] See Secs. 402(4)(b), and 402(4)(h) Canadian Income Tax Regulations.

[1849] See Article 96(4) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS). Notably, the third country rule is an expression of the water's edge limitation.

[1850] Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), argue at 213 that the use of a throw-out rule would be more sensible than using a throwback rule as 'nowhere' sales would simply be ignored under its application rather than assigned to the origin jurisdiction.

- the 'state of the purchaser to which the property is delivered or shipped, regardless of the f.o.b. point or other conditions of the sale' (US);[1851]
- the location of the customer to which the services are sold (US);[1852]
- the 'place where the goods are located at the time when the supply takes place' (EU-VAT);[1853]
- the 'place where dispatch or transport of the goods to the person acquiring them ends' (EU-VAT);[1854]
- the 'place of importation' (EU-VAT);[1855]
- the place of the customer's 'business establishment', 'permanent address', or 'usual residence',[1856] i.e., its tax place of residence (EU-VAT regarding B2B-services);[1857]
- the place of the customer's 'fixed establishment', i.e., its permanent establishment (EU-VAT regarding B2B-services);[1858]
- the 'place where the customer is established, has his permanent address or usually resides', i.e., the customer's tax place of residence (EU-VAT regarding telecommunication, broadcasting and electronic services);[1859]
- the 'place of effective use and enjoyment of the services' (EU-VAT).[1860]

In my view, the sales factor could best be attributed by approximating the customer location as closely as possible. Assessing the available approaches, I would advocate the following allocation standards:

- *B2C sales of tangible goods*. As a rule, B2C sales of tangible goods would be assigned to the place where these are located at the time that the economic risks involving the products pass from the seller to the third-party buyer. If the goods are

[1851] See Article IV.16(a) Multistate Tax Compact: *"Sales of tangible personal property are in this State if (a) the property is delivered or shipped to a purchaser, other than the United States Government, within this State regardless of the f.o.b. point or other conditions of the sale."*
[1852] See Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 229 (footnote 46). Notably, Hellerstein refers to *"a number of states (…) explicitly abandoning the use of this traditional 'place of performance rule' for a 'market state' or customer location rule for assigning receipts from sales of services to the sales factor."* Hellerstein also mentions EU-VAT taking a similar approach in this respect. Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), refers to Ohio as a state that moved to sourcing services at destination.
[1853] See Article 31 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.
[1854] That is, to locate intra-European Union acquisitions of goods. See Article 40 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.
[1855] That is, in cases where dispatch or transport of the goods begins outside European Union territories. See Article 32 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax
[1856] See Article 44 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax: *"The place of supply of services to a taxable person acting as such shall be the place where that person has established his business. However, if those services are provided to a fixed establishment of the taxable person located in a place other than the place where he has established his business, the place of supply of those services shall be the place where that fixed establishment is located. In the absence of such place of establishment or fixed establishment, the place of supply of services shall be the place where the taxable person who receives such services has his permanent address or usually resides."*
[1857] Cf. Court of Justice, Case C-73/06 (*Planzer Luxembourg Sarl*). See for a comparison Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 53. Notably, EU-VAT adopts an origin based approach with regards to B2C-transactions, see Article 45 Council Directive 2006/112/EC.
[1858] *Ibidem*. Worth noting is that the concepts of place of resident and permanent establishment to locate the customer in EU VAT are similar to those in international taxation. See also Rebecca Millar, 'Echoes of Source and Residence in VAT Jurisdictional Rules', *Sydney Law School Research Paper* 2009:44, and Rebecca Millar, 'Intentional and Unintentional Double Non-Taxation Issues in VAT', *Sydney Law School Research Paper* 2009:45.
[1859] See Article 58 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax. Notably, with regards to intangible B2C services this destination based place of supply rule currently applies only to non-European Union based service providers supplying to European Union customers. Today, an origin based place of supply rule applies when EU-based businesses provide such intangible services. For EU-VAT purposes, these businesses are currently considered to supply these intangible services at the place of their tax residence, or the place where they operate a permanent establishment. However, the scope of the aforementioned destination based place of supply rule has been extended to also apply to European Union-based service providers as of 1 January 2015. See Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services.
[1860] See Article 59a(a) and (b) Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax. This place of supply rule is available for the Member States to apply as a back-stop rule to prevent double taxation, non-taxation or distortion of competition. The interpretation of this rule is indistinct though.

transported, the sales would be assigned to the place of residence of the customer. That is, to approximate its place of consumption.[1861] Administratively, for this purpose, one may refer to the customer's delivery address, or billing address, or alternatively its bank or credit card details – e.g., the place of the account used for (online) payment, or the customer's billing address held by the bank involved.

- *B2B sales of tangible goods.* B2B sales of tangible goods would be assigned to the place where these are located at the time that the economic risks involving the products pass from the seller to the third-party buyer. Administratively, one could make use of the selling conditions involving the economic risk transfer in the underlying trading contracts. That would effectively introduce an approach that matches the applied International Commercial Terms (incoterms) in international trade ('Ex Works', 'Free on Board', 'Delivery Duty Paid', et cetera). To the extent that the application of this rule would locate (subsequent) sales in international waters, those sales would be reapportioned to the place of importation chronologically succeeding the economic risk transfer.

- *B2C supplies of services including intangible sales*. B2C supplies of services and intangible sales (internet, telecommunication, et cetera) would be assigned to the place where the customer resides. Administratively, drawing inspiration from the literature and EU-VAT practices, one could refer for this purpose to the customer's (billing) address, or the customer's bank or credit card details.[1862] With regards to electronic services provided (internet), reference can be made to the 'location of the residential fixed land line through which the service is supplied'.[1863] One could also think of using the various available electronic geo-location methods to locate the e-sale, e.g., the 'Internet Protocol (IP) address of the device used', or 'the Mobile Country Code (MCC) of the International Mobile Subscriber Identity (IMSI) stored on the Subscriber Identity Module (SIM) card that is used by the customer'.[1864]

- *B2B supplies of services including intangible sales*. B2B supplies of services and intangible sales (internet, telecommunication, et cetera) could be assigned to the place where the customer functionally utilizes these services in its business process. To the extent that the customer is active only in a single jurisdiction, the approach taken would be identical to that regarding B2C services and intangible sales.

  To the extent that the customer of the B2B intangible sales transaction operates a multijurisdictional business itself and utilizes the services internationally (e.g., cross-border software licensing contracts), some kind of attribution needs to be undertaken. To my knowledge, little guidance is available here. In my view, as it would involve third-party transactions, an assessment of the contractual arrangements involved would allow coming a long way in identifying the places of functional utilization by the customer. The use of electronic geo-location methods may be useful when it concerns the provision of e-services. Nevertheless, a back-stop rule may be required

[1861] See for a comparison,
Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, referring to the place of consumption at 53.
[1862] See e.g., European Commission, *Proposal for a Council Regulation amending Implementing Regulation (EU) No 282/2011 as regards the place of supply of services*, COM(2012) 763 final, 2012/0354 (NLE), Brussels, 18 December 2012. See also Walter Hellerstein, 'State Taxation of Electronic Commerce', 52 *Tax Law Review* 425 (1996-1997), at 497-499, Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce', 52 *Tax Law Review* 507 (1996-1997), at 510. See also Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000), referring to Hellerstein, at 1671, and Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 218-219, also referring to Hellerstein.
[1863] See European Commission, *Proposal for a Council Regulation amending Implementing Regulation (EU) No 282/2011 as regards the place of supply of services*, COM(2012) 763 final, 2012/0354 (NLE), Brussels, 18 December 2012.
[1864] *Ibidem*. Worth noting is a recent Dutch VAT ruling rendered by the Amsterdam Tax Court of Appeals involving the localization of chat sessions services provided to customers over the internet. The Court upheld the approach taken by the respective enterprise of locating the customers for VAT purposes by reference to their credit card details and IP-numbers. See Amsterdam Tax Court of Appeals, Gerechtshof Amsterdam, 24 May 2012, no. 11/00577, Vakstudie-Nieuws 2013/2.22.

to counter arbitrage and potential misuse. Drawing inspiration from the 'place of effective use and enjoyment of the services' rule in EU-VAT, the 'significant people functions' in international taxation, and the 'payroll factor' in formulary apportionment, I would advocate using a fractional approach on the basis of which the sales regarding that B2B-customer would be assigned geographically by reference to the customer's payroll in such cases. Then, customer payroll would be used to proportionally approximate the supplier's turnover at destination.

This boils down to the following nexus/allocation sales factor: 'sales State A = ales $*$ $\frac{\text{sales consumed or utilized in State A}}{\text{overall sales supplied}}$'.[1865] Kindly note that the reference to a fraction is needed to deal with intangibles sales that are utilized in more than one taxing jurisdiction. Incidental sales would be disregarded under a *de minimis* nexus threshold rule equivalent to the distance sales rules in EU-VAT. That rule would be defined as 'nexus if sales state A exceed amount $, ¥, or €x' (e.g., $, ¥, or €50,000), or 'nexus, alternatively, if the aggregate formula attributes more than x% of profits' (e.g., 25%).[1866] Notably, the currency used would differentiate per taxing state – currency issues are discussed hereunder.

I feel that such an approach would capture the destination state in most cases. For the dealing with exceptionalities, inspiration may be drawn from the place of supply rules in EU-VAT.[1867] I consider EU-VAT place of supply rules to approximate the destination state somewhat better than its equivalents in formulary apportionment do. Further, the use of the nexus threshold standard will ensure that insignificant selling volumes would not lead to a taxable presence. In effect, those sales would be attributed proportionally to the taxing jurisdictions in which the taxpayer has a taxable presence.

That would perhaps effectively come a long way in cancelling out artificial tax base shifting through sales factor manipulation. Viz., the shifting of profit through the shifting of the sales factor in that event would require a relocation of the multinational's marketplace, a shift in real firm outputs accordingly. Manipulation, for instance, of the sales factor in the CCCTB sharing mechanism would be tackled as revenues from portfolio investments, hedging transactions, and exempt revenues would be excluded from the sales factor. Factoring inflation by engaging into intra-group transactions would be infeasible as intra-group sales would also be excluded from the factor. Finally, the risk of inducing artificial tax planning operations involving third-party transactions would seem quite remote in my eyes.[1868]

[1865] Please note that to the extent the application of the fraction involves a sale that is utilized solely within a single state, the application of the fraction with regard to that sale would be 1.

[1866] The alternative rule would apply if the first mentioned nexus standard has not been met; cf. Multistate Tax Commission, *Federalism at Risk, A Report of the Multistate Tax Commission*, June 2003, at Appendix D.

[1867] See Title V Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

[1868] Within the context of the CCCTB proposal, the Committee on the Internal Market and Consumer Protection proposed to take out the sales factor from the sharing mechanism for it allegedly being perceived easy to manipulate: *"An independent sales agent (located in a non-CCCTB State) could be contracted as an intermediary to do the sales on behalf of the group to the relevant market, and thereby move the destination of the sales from the 'intended' state to the state of choice,"* Opinion of the Committee on the Internal Market and Consumer Protection for the Committee on Economic and Monetary Affairs on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB), (COM(2011)0121 – C7-0092/2011 – 2011/0058(CNS)), 25 January 2012. I doubt whether such manipulation would arise. I do not see the incentive. The planning would require the undertaking of third-party market transactions underlying the tax saving. Without the economic risk passage there would be no third-party sale. The intermediary third party would charge a (taxable and allocable) fee for its services as it would bear the economic risk involving the performing of its reselling function. That would erode the seller's profit margin. Furthermore, in cases of sales of tangibles such a tax planning operation would likely trigger additional transportation costs. Finally, there still is the theory of the firm, i.e., the explaining of the firm's existence by reference to the economic benefits of integration. Such a third-party tax planning operation would require the breaking up of the multinational into functionally disintegrated parts among the production-distribution chain. Due to the needed third-party reseller, the benefits of integration at that stage in the chain would need to be given up to obtain a tax saving. Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 20, note that: *"While it is possible that taxpayers may try to avoid taxation by using independent distributing agents for their sales, it is unlikely that they would be willing to relinquish real control over their marketing and distribution activities, since that is why they are organized in MNE form in the first place."* To my knowledge the issue also does not arise in European Union value added taxation. For a similar discussion, see Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 52, *An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB*, Taxud E1 AAG-GR-FF, CCCTB\WP\052\doc\en, Brussels, 27 February 2007, at 9 (par. 43), Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 56, *Report and overview of the main issues*

Intermezzo; the 'value added key at destination': an ill-featured alternative indeed

Notably, before wrapping this section up, the following should be mentioned. It has been noted in the literature that it may also be considered to geographically attribute value added at destination.[1869] The suggestion basically mirrors the value added at origin proposals forwarded in the literature mentioned in the above.

Such a value added key would require taking into account costs incurred at destination, rather than the mere gross receipts – the latter being the case at hand under a sales factor. *"Such a determination would require the attribution of overhead and other costs to sales made to various destinations, creating (…) compliance and administrative problems and opening the way for manipulation of the attribution of value added."*[1870] The need to geographically allocate costs under such a destination-based value added attribution key, firm inputs accordingly, would produce issues similar to those under the property factor in formulary apportionment and cost attribution in transfer pricing. I can only agree that *"[a]pportionment based on value added at destination seems to be totally unworkable."*[1871]

Notably, analytically similar issues to those set forth in the above paragraph would arise under a destination-based cash flow tax discussed in the previous chapter, Chapter 5, section 7. The operation of a cash flow tax requires a geographic attribution of the firm's outbound cash flows – the firm inputs that is. That requires an allocation of inputs equivalent to those under a destination based value added key. It accordingly creates issues equivalent to those set forth in the above paragraphs as well.

In my view, the use of gross receipts – firm outputs accordingly – would suffice to attribute tax base geographically. Please keep in mind that the aim here is to divide the tax base, not to define it.

6.4.5 Deciding on the matter: towards destination based sales only apportionment

6.4.5.1 The effects of apportioning to input locations and output locations: real profit shifting

This section addresses the economic implications of formulary apportionment. A known property of formulary mechanisms is that they provide an incentive to locate apportionment factors in low-taxing jurisdictions.[1872] The available theoretical literature and empirical research on formulary systems suggest that in the presence of differentials in effective average tax rates, multinationals engage in real profit shifting through factor shifting where tax jurisdictions respond by engaging in a tax competition game to attract and preserve

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that emerged during the discussion on the sharing mechanism SG6 second meeting – 11 June 2007, Taxud E1 OP, CCCTB\WP\056\doc\en, Brussels, 20 August 2007, at 10 (par. 37), and Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 12 (par. 45). See also Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 237. The Commission cannot accept the Committee's amendments. See Commission Communication on the action taken on opinions and resolutions adopted by Parliament at the April 2012 part-session, (SP(2012)388), 30 May 2012.

[1869] See Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), 199-220, at section 4.4.3.

[1870] *Ibidem*, at 216.

[1871] *Ibidem*, at 217.

[1872] See Walter Hellerstein, 'Tax Planning under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012) 221, at 233, and Joann M. Weiner, 'Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level', 13 *Tax Notes International* 2113 (23 December 1996), at 2137. See also Opinion of the European Economic and Social Committee on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121 final – 2011/0058 (CNS), ECO/302, 26 October 2011, at 1.2.6, as well as Albert van der Horst et al, 'Will corporate tax consolidation improve efficiency in the EU?', *Tinbergen Institute Discussion Paper* 2007:076/2.

investment, employment and sales.[1873] Also, formulary systems produce tax competition. *"[A]s long as the apportionment mechanism relies on mobile factors under the control of the company, FA creates incentives for firms to shift factors across countries to minimize the groups' overall tax burden and thereby it may give rise to certain tax competition by governments to attract real economic activity into their territories, which may create some economic distortions. The potential distortions and economic effects of FA depend on the degree of mobility of the factors chosen. In general, the more weight on mobile factors, the more likely are the distortions regarding the allocation of factors."*[1874] Hence, the mobility of the formula factors drive the mobility – or the elasticity – of the tax base.[1875]

It should be noted that the incentives referred to at this point in this study revolve around real profit shifting through the shifting of real inputs and outputs. It should be kept in mind that these matters do not involve the artificial profit shifting incentives c.q. tax avoidance operations.[1876] These artificialities have already been extensively dealt with in the above sections.

To assess the economic implications of formulary mechanisms further, it is helpful to follow the various economists who consider the application of apportionment formulae to roughly correspond to the imposition of separate taxes on the factors used in the formula – the burden of which is shifted to the firm's workers, owners and customers.[1877] Seen from that perspective, the traditional three-factor formula, for instance, would operate like a bundle of implicit excise taxes on payroll, assets and sales. The 'tax-on-factor effect' would then be seen as effectively transforming the corporate tax into a payroll tax, a property tax and a sales tax.[1878] The 'payroll tax', the 'property tax' and the 'sales tax' components would be considered to be borne respectively by the firm's workers, owners and customers. From this it

[1873] See Charles E. McLure, Jr., 'The State Corporate Income Tax: Lambs in Wolves' Clothing', in Henry J. Aaron et al (eds.), *The Economics of Taxation* (1980) 327, at 327-346, Roger Gordon et al, 'An Examination of Multijurisdictional Corporate Income Taxation under Formula Apportionment', 54 *Econometrica* 1357 (1986), Austan Goolsbee et al, 'Coveting thy neighbor's manufacturing: The dilemma of state income apportionment', 75 *Journal of Public Economics* 125 (2000), at 125-143, Kelly D. Edmiston, 'Strategic Apportionment of the State Corporate Income Tax', 55 *National Tax Journal* 239 (2002), at 239-262, Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 5 and 48, Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at Chapters 5 and 6, and Thomas C. Omer et al, 'Competitive, Political, and Economic Factors Influencing State Tax Policy Changes', 26 *Journal of the American Taxation Association* 103 (2004), at 103-126, who conclude that *"that state governments compete for capital and jobs and respond to their competitors' tax policy decisions with conforming policy changes"*.

[1874] See Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 9-10 (par. 22-23).

[1875] Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 57.

[1876] See for a comparison Joann M. Weiner, 'Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level', 13 *Tax Notes International* 2113 (23 December 1996), at 2137 where she refers to the incentives under formulary systems to shift formula factors to comparatively low-taxing jurisdictions.

[1877] The first to forward this approach has been McLure, Charles E. McLure, Jr., 'The State Corporate Income Tax: Lambs in Wolves' Clothing', in Henry J. Aaron et al (eds.), *The Economics of Taxation* (1980) 327, at 327-346. See also, e.g., Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 12, Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 10 (par. 24), Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at Chapter 5, Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at Chapter IV. See finally Kelly D. Edmiston et al, 'Economic Effects of Apportionment Formula Changes: Results from a Panel of Corporate Income Tax Returns', 34 *Public Finance Review* 483 (2006), at 485: *"A series of papers in the 1980s established that, to the extent tax rates vary across jurisdictions, formula-apportioned corporate income taxes are similar in their incidence to a set of implicit excise taxes on the apportionment factors (…). That is, the economic effects mimic the effects of sales taxes, payroll taxes, and property taxes."*

[1878] The term 'tax-on-factor effect' has been taken from Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 263.

would follow that, in the presence of effective tax rate differentials, there is an incentive for firms to localize the factors in the comparatively low taxing jurisdiction. That would incentivize countries to respond by reducing the effective tax rate to attract these factors to their territories.

The question of whether a formulary apportionment mechanism indeed transforms the corporate tax economically into excise taxes on the formula factors, in my view, depends, first on the question of whether the tax is actually borne by these factors in proportion to their weighting under the formula used. Indeed, the excise effect has been observed in the empirical literature.[1879] However, it remains uncertain whether the tax is necessarily always borne by the factors in the formula. At the end of the day, the tax incidence in a particular scenario is unknown as this depends on the relative elasticity in supply and demand in the respective markets involving the factors used.[1880] It is not a given that the corporate tax is actually and necessarily borne by the firm's workers, owners and customers in proportion to the factor weighting. The incidence depends on the given price elasticity in the labor markets, the capital markets and the customer markets at a given time and place. It follows that the hypothesis that the tax in terms of tax incidence operates as an excise tax holds only under the assumption that the tax is proportionally borne by the factors in the formula – an assumption which, to my understanding, cannot be validated; at least, not until today. Nevertheless, regardless of the theoretical merits of the 'excise tax effect', the available empirical evidence, as said, does suggest multinational factor shifting and country tax competition responses.

Furthermore, second, it should be kept in mind that formulary apportionment divides the tax base; it does not define it. The tax remains a corporate tax on rents, regardless of its apportioning and incidence. *"[T]ax liabilities do not arise unless an MNE is earning profits worldwide."*[1881] *"In this sense, a tax on capital is a tax on capital is a tax on capital."*[1882]

Out of the available factors, the asset factor is generally considered the most mobile formula factor. This is because firms have full control over where to geographically locate these inputs.[1883] The labor factor is considered relatively less mobile, since it is less controllable by the firm. That is regardless of the fact that the labor factor still may be considered controllable to a certain extent because of the multinational firm's economic power over its workforce and is, hence, mobile to a certain extent as well. The discussions in current transfer pricing practice on the allocation of location savings involving the shifting of production to low wage cost countries[1884] suggests by inference that firms do have some control on the geographic

[1879] See Kelly D. Edmiston et al, 'Economic Effects of Apportionment Formula Changes: Results from a Panel of Corporate Income Tax Returns', 34 *Public Finance Review* 483 (2006), at 483-504, and Austan Goolsbee et al, 'Coveting thy neighbor's manufacturing: The dilemma of state income apportionment', 75 *Journal of Public Economics* 125 (2000), at 125-143.

[1880] See for a comparison Michael J. McIntyre, 'Thoughts on the Future Of the State Corporate Income Tax', 25 *State Tax Notes* 931 (23 September 2002), at 936-938, and Peter Harris, 'The CCCTB GAAR: A Toothless Tiger or Russian Roulette?', in Dennis Weber (ed.), *CCCTB Selected Issues* (2012)
, 271-297, at 278.

[1881] Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 14.

[1882] See Peter Mieszkowski et al, 'The National Effects of Differential State Corporate Income Taxes on Multistate Corporations', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 253, at 257. Mieszkowski and Morgan argue that a tax on capital returns, on balance, remains such a tax under a formulary approach in the presence of tax rate differentials, i.e., despite the locational distortions.

[1883] Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 52, and Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 10 (par. 24).

[1884] On location savings and the question as to which jurisdiction to allocate them, see 26 CFR 1.482-1(d)(4)(ii)(C) for the implications under US international tax law, and *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2010, Chapter IX, at par. 9.148-9.153, for the OECD's views on the matter. For some analysis, see Steven N. Allen et al, 'Location Savings – A US Perspective', 4 *International Transfer Pricing Journal* 158 (2004), at 158-164. All basically agree that the allocation of the location savings depends on the relative bargaining position of the parties involved in the transaction. Accordingly, the economic benefits of the location savings accrue to the party with the most bargaining power, for instance, as derived from that party's non-routine intangible asset ownership. For a comparison see UN Practical Transfer Pricing Manual for Developing Countries, that tends to assign location savings to the low wage cost country. For some reading and analysis on the impact of

localization of their workforce.[1885] The sales at destination factor is generally considered the least mobile formula factor, since – according to economic theory – sales are immobile because the demand curve is driven by the market, and lies outside the firm's control for that reason.[1886] *"Firms have no control over where customers are located."*[1887]

Available analyses suggest that the tax indeed is quite likely to be borne by the least mobile and economically least powerful market parties involved.[1888] In view of that, it seems to follow that the firm's workers and consumers are likely to end up bearing the tax.[1889] *"FA may therefore have some incidence effects on workers and consumers if greater weight is assigned to labour or 'sales by destination' respectively."* To which extent would things differ from the current SA/ALS system in international taxation? I am not sure.[1890] The current international tax system seeks to geographically localize taxable profit basically by reference to the place where the 'significant people functions' are performed, i.e., the jurisdiction of origin where the firm's workers conduct the firm's business activities. I can imagine that, under the current approach, the effective corporate tax burden ends-up being shifted to these 'significant people' as well, perhaps producing an incidence pattern comparable with that under the labor factor in formulary apportionment. Matters do not seem too dissimilar to that extent, analytically that is, particularly considering the conceptual resemblances between 'significant people functions' and 'payroll-FA' already identified in the above.[1891] This, however, is not further discussed.

Available analyses further reveal the following effects. With regards to the origin-based firm inputs factors, it has been found that the comparative reduction by taxing jurisdictions of the weights put on the payroll factor and the asset factor (relative to sales factor weight decreases) has the effect of attracting and stimulating (new) employment and (new) investment in the respective taxing jurisdiction involved.[1892] Weight increases on these factors

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the manual for China, see Glenn DeSouza, 'What the UN Manual Really Means for China', 41 *Intertax* 331 (2013), at 331-338.

[1885] Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 60, *CCCTB: possible elements of the sharing mechanism*, Taxud TF1/GR/FF, CCCTB/WP060\doc\en, Brussels, 13 November 2007, at 12 (par. 45)

[1886] See Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 717, Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 12, Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 8 (par. 17), Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 52, *An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB*, Taxud E1 AAG-GR-FF, CCCTB\WP\052\doc\en, Brussels, 27 February 2007, at 11 (par. 50).

[1887] See Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 32.

[1888] Cf. Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 10 (par. 24).

[1889] See e.g., Clemens Fuest et al, 'Which workers bear the burden of corporate taxation and which firms can pass it on? Micro evidence from Germany', *Oxford University Centre for Business Taxation Working Paper* 2012:16. The authors provide empirical evidence on the wage incidence of the German Gewerbesteuer levied at municipal level. They find that it takes up to two years for the corporate tax burden to be (partly) shifted to labor. The burden seems to be largely borne by incumbent workers; vulnerable workers (low-skilled workers, women, part-time workers and individuals with 'low firm specific tenure') share a relatively higher tax burden. See also Dietmar Wellisch, 'Taxation under Formula Apportionment - Tax Competition, Tax Incidence, and the Choice of Apportionment Factors', 60 *FinanzArchiv* 24 (2004), at 24-41, who argues that a payroll-only formula is borne by the firm's workers. A sales-only formula would shift the burden to the consumer.

[1890] For some analysis, see Roger Gordon et al, 'An Examination of Multijurisdictional Corporate Income Taxation under Formula Apportionment', 54 *Econometrica* 1357 (1986), at 1357-1373, and Søren Bo Nielsen et al, 'Tax Spillovers under Separate Accounting and Formula Apportionment', *EPRU Working Paper Series* 2001:07.

[1891] The resemblance has also been identified by Reuven S. Avi-Yonah et al, 'Formulary Apportionment – Myths and Prospects; Promoting Better International tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative', 3 *World Tax Journal* 371 (2011), at 393.

[1892] On the effects on the reducing of weights on the payroll factor, see Austan Goolsbee et al, 'Coveting thy neighbor's manufacturing: The dilemma of state income apportionment', 75 *Journal of Public Economics* 125 (2000), at 125-143. On the effects of reducing the weight on the property factor, see Sanjay Gupta et al, 'The Effect of State Income Tax Apportionment and Tax Incentives on New Capital Expenditures', 25 *Journal of the American Taxation Association* 1 (2003), at 1-25, and Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at Chapter 5.

reduce the demand for labor and capital in these jurisdictions.[1893] The assignment of tax base to the jurisdiction(s) of origin, thus, is not neutral towards the decision as to where to geographically locate production.[1894] Canada, for instance, operates a two factor payroll-sales formula excluding the asset factor from the formula, thereby eliminating the direct location distortion to the production factor of capital.[1895] The exclusion of payroll would eliminate the location distortion to the production factor of labor.[1896] Sales-only apportionment promotes neutrality towards the decision as to where to locate production factors.[1897]

With regards to the destination-based firm outputs factor the following effects arise. It has been found that the inclusion, comparatively, of relative weight increases on the sales factor relative to the reduction of weights put on the input factors have the effect of attracting and stimulating (new) employment and (new) investment in the respective taxing jurisdiction involved.[1898] Sales factor weight increases, however, push relative commodity prices in the taxing state upwards, whereas weight decreases lowers them, relatively that is.[1899] The sales factor accordingly affects the decisions as to where to sell. The sales factor promotes production factor neutrality.[1900] A domestic investment *"would not be advantaged or disadvantaged compared to an investment abroad, and all multinationals that sell* [locally] *or* [abroad] *would be taxed on an equal basis, whether they are considered to be* ["national"] *or "foreign"."*[1901] Sales only apportionment, however, does not produce market neutrality – which calls for neutrality in deciding where to both produce and sell – as it would distort the selling location.[1902]

Regardless of this, it has been argued in the literature that firms still have an incentive under the sales factor to sell as much product as possible, even in jurisdictions putting a relatively

[1893] See Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 48. Garcia, referring to Wellisch, notes that this explains the hostile attitude of unions towards payroll-FA – taking into mind the incidence on employment.

[1894] Cf. Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 49 and 52.

[1895] See Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 17.

[1896] See for a comparison Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 14.

[1897] See e.g. Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 267: *"if a destination-based receipts factor is used in the apportionment formula, the portion of profits allocated according to that factor will be distributed irrespective of the place where the enterprise has established itself. As far as this amount is concerned, the enterprise will not benefit from moving activities to a jurisdiction with a lower tax rate, which will reduce the incentive effect of rate differentials and therefore the effects of tax competition,"* and Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 52: *"thus the distortions from destination taxes will generally be smaller than those from origin taxes (i.e., a sales by destination factor complies better with the neutrality criterion). Greater relative weight on the sales factor would increase the excise tax effect on sales and reduce it on payroll and property, which is likely to create smaller overall efficiency costs from corporate taxation."*

[1898] See Bharat Anand et al, 'The weighting game: formula apportionment as an instrument of public policy', 53 *National Tax Journal* 183 (2000)', at 183-199, and Roger Gordon et al, 'An Examination of Multijurisdictional Corporate Income Taxation under Formula Apportionment', 54 *Econometrica* 1357 (1986), at 1357-1373. Gordon and Wilson refer to an effect that they call 'cross-hauling', i.e., the incentive to shift production towards the jurisdiction that puts a relatively higher tax burden on sales, and the incentive to shift sales towards the jurisdiction that puts a relatively higher tax burden on payroll and assets (and conversely to the extent that the relative burdens are lower).

[1899] See Peter Mieszkowski et al, 'The National Effects of Differential State Corporate Income Taxes on Multistate Corporations', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 253, at 254.

[1900] See e.g., Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 267: *"(…) if a destination-based factor is used in the apportionment formula, the portion of profits allocated according to that factor will be distributed irrespective of the place where the enterprise has established itself. As far as this amount is concerned, the enterprise will not benefit from moving activities to a jurisdiction with a lower tax rate, which will reduce the incentive effect of rate differentials (…)."*

[1901] See Reuven S. Avi-Yonah, 'Slicing the Shadow: A Proposal for Updating U.S. International Taxation', 58 *Tax Notes* 1511 (15 March 1993), referring to the US as the domestic jurisdiction.

[1902] The term market neutrality has been derived from Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 700, 707 and 716. Devereux argues that global optimality or market neutrality requires full harmonization across countries.

higher weight on the sales factor.[1903] Economic ratio dictates that firms would still want to sell in high-tax sales-only FA jurisdictions to serve their customers to the extent that business is profitable.[1904] Such an incentive to sell regardless of the presence of a factor taxing it is absent at the supply side regarding the payroll and asset factors. That is, because each currency value in tax savings at the supply side that is achieved by the shift of inputs to the comparatively lower taxing jurisdiction commercially equals a cost savings. Only a zero tax burden on firm inputs cancels out this incentive. Accordingly, the locational distortions at the demand side (outputs) seem less significant relative to the distortions at the supply side (inputs), theoretically that is.

All in all, it seems that *"[l]abor, capital and consumers in high-tax state(s) are "taxed" as the result of the higher rates of corporate tax. In contrast, factors of production and consumers in nontaxing states are "subsidized" by apportionment. From an overall (…) perspective, the local effects of apportionment tend to cancel each other out."*[1905] Accordingly, *"as long as tax rates continue to differ across (…) [s]tates, economic inefficiencies will exist under formulary apportionment."*[1906] It has therefore been argued that from a global welfare optimization perspective, taxing jurisdictions would fare optimally under a harmonized approach where all taxing jurisdictions involved would apply identical systems under identical tax rates.[1907] That would, however, encounter tax sovereignty issues; these are discussed as a separate matter in section 6.4.5.4.

6.4.5.2 Towards destination-based sales-only apportionment

In the presence of effective tax rate differentials – a non-harmonized tax environment – it has been observed that taxing jurisdictions would serve their economic self-interest best if they adopt a single destination-based sales-only formula.[1908] Sales-only formulae are generally seen as effective economic development tools.[1909] They incentivize domestic investment and employment and accordingly promote economic growth and job creation. From the perspective of an origin oriented taxing jurisdiction, e.g., under SA/ALS or payroll-assets formulary apportionment, the sales at destination-oriented taxing jurisdiction would appear as a production tax haven to which the origin jurisdiction loses employment and investment, i.e., as the latter would not tax domestic inputs.[1910]

[1903] See Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 12.
[1904] *Ibidem*, at 14. The incentive will fade out only if the effective average tax rate exceeds 100%, i.e., as the tax remains a tax on rents rather than a sales tax.
[1905] See Peter Mieszkowski et al, 'The National Effects of Differential State Corporate Income Taxes on Multistate Corporations', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 253, at 254.
[1906] See Joann M. Weiner, 'Taxation Papers; Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *European Commission Directorate-General Taxation & Customs Union Working paper* 2005:8, at 43 referring to Marcel Gérard et al, 'Cross-Border Loss Offset and Formulary Apportionment: How do they Affect Multijurisdictional Firm Investment Spending and Interjurisdictional Tax Competition?', *CESIfo Working Paper* 2003:1004. See also Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000), at 1604-1606.
[1907] See for a comparison Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 700, 707 and 716. The similar argument has been used to advocate using uniform formulae in US state taxation, see Bharat Anand et al, 'The weighting game: formula apportionment as an instrument of public policy', 53 *National Tax Journal* 183 (2000), at 183-199, as well as Austan Goolsbee et al, 'Coveting thy neighbor's manufacturing: The dilemma of state income apportionment', 75 *Journal of Public Economics* 125 (2000), at 125-143. See for a comparison Joann M. Weiner, 'Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level', 13 *Tax Notes International* 2113 (23 December 1996) who refers to the investment location distortions that arise under the present non-harmonization of state formulae in the US.
[1908] See Kelly D. Edmiston, 'Strategic Apportionment of the State Corporate Income Tax', 55 *National Tax Journal* 239 (2002), at 239-262, Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 13.
[1909] See Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 56.
[1910] See Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 21.

If one state introduces a destination-based taxable profit attribution system, this creates an incentive for other states to establish a conforming tax policy, abolishing their origin-oriented tax attribution systems to introduce a destination-based system as well. *"[I]f some countries adopt sales-based formulas, other countries will have an incentive to adopt sales-based formulas as well, in order to avoid losing payroll or assets to countries in which these factors are not part of the formula." "[O]nce one state has made that move, it is in every state's interest to move to a single-factor formula.*[1911] *(…) [T]he result will be that all states use a destination-based sales formula."*[1912] This is not just theory. Experiences in US state income taxation reveal an impressive trend for US states to increase the weight on the sales factor ever since the US Supreme Court constitutionally validated sales-only apportionment in the case of *Moorman*.[1913] The rush towards sales-only apportionment in US state income taxation continues today.[1914]

So, which approach should be chosen from a welfare economics perspective: origin, destination or a combination thereof? Following the various eminent economists I would favor adopting a destination-based tax base division approach.[1915] A destination based corporate tax system would promote a global efficient and non-discriminatory allocation of resources. The allocation of firm rents to the market jurisdiction under such a system would accordingly eliminate the incentives to shift taxable profit by shifting controllable firm inputs across tax borders. Under a destination based allocation, *"firms would have no incentive to shift income across countries because tax liabilities would be based on total world income as well as on the share of a firm's sales that occur in each destination. Since there would be no tax savings associated with shifting income across countries, the overall incentive to locate real activities in low-tax countries would also be reduced."*[1916] Taxing rents at destination would accordingly reduce the tax distorted multinational decision-making as to where to invest, i.e., relative to the current origin-oriented international tax regime.

Furthermore, a destination-based allocation of firm rents would likely reduce the elasticity – or mobility – of the tax base relative to the current system. In the presence of rate differentials, a destination-based tax base division would remain to distort the sales locations; i.e., market neutrality would not be achieved since a comparatively lower taxing jurisdiction, as said, would be relatively more attractive to sell (firm's perspective) and buy (customer's perspective). Yet, the tax base would be relatively inelastic since firms would be unable to significantly affect the demand-side.[1917] Customers are considerably less mobile than the firm's assets and workforce.[1918] In addition, as said, firms *"have an incentive to encourage*

[1911] *Ibidem*, at 13.
[1912] See Joann M. Weiner, 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', *Directorate-General Taxation & Customs Union Taxation Paper* 2005:8, at 42.
[1913] See United States Supreme Court, *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 98 S. Ct. 2340 (1978).
[1914] See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold et al (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, at 249, and Walter Hellerstein et al, 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States', 11 *International Tax and Public Finance* 199 (2004), at 208, Carol Douglas, 'More Single-Sales-Factor States', 37 *State Tax Notes* 259 (25 July 2005), at 259-260, Stefan Mayer, *Formulary Apportionment for the Internal Market* (2009), at 95, and Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 47, *The Mechanism for sharing the CCCTB*, Taxud E1, GR/FF, CCCTB\WP\047\doc\en, Brussels, 17 November 2006, at 8-9 (par. 18). For an overview of the formulae adopted by the US States as of January 1, 2013, see David Spencer, 'Unitary taxation with combined reporting: The TP solution?', *International Tax Review* (2013), 25 April 2013, at 2-5.
[1915] See Alan J. Auerbach et al, 'Taxing Corporate Income', *Oxford University Centre for Business Taxation Working Paper* 07/05, Paper Prepared for the Mirrlees Review, *Reforming the Tax System for the 21st Century* (2008), Alan J. Auerbach, 'A Modern Corporate Tax', *The Hamilton Project Discussion Paper* 2010, Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, Reuven S. Avi-Yonah, 'Slicing the Shadow: A Proposal for Updating U.S. International Taxation', 58 *Tax Notes* 1511 (15 March 1993), Reuven S. Avi-Yonah, 'Slicing the Shadow: A Proposal for Updating U.S. International Taxation', 135 *Tax Notes* 1229 (4 June 2012), at 1229-1234 and William F. Fox et al, 'How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?', 53 *National Tax Journal* 139 (2005), at 139-159.
[1916] See Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 12.
[1917] See e.g., John Watson, 'Multinationals and The Great Tax Debate', *LexisNexis*, December 2013, available at http://www.taxjournal.com/tj/articles/special-report-multinationals-and-great-tax-debate-10012014, at 5: *"a firm cannot move its customer base at will."*
[1918] See Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission*

sales in each market in order to serve the customers there."[1919] *"Even in a high-tax country, firms still have an incentive to sell as much as possible."*[1920] The immobility of the tax base may accordingly significantly mitigate both multinational profit shifting incentives and country tax competition responses.

The ideal would be to adopt a destination-based tax base attribution approach on a coordinated basis, e.g., on a global scale under the umbrella of the United Nations,[1921] or regionally, at the levels of the North American Free Trade Association and the European Union. *"If the formula is adopted worldwide, it will by definition not distort investment location decisions (…), and can even encourage open markets and free trade."*[1922] *"Given that the EU is already pursuing the possibility of FA within Europe, a natural forum for reaching international consensus on these issues would be the OECD. With international cooperation, the possibility of double or non-taxation would be reduced and there would be less room for MNEs to respond strategically to variations in country formulas."*[1923]

Also, in the event that it would be impossible to attain a consensus to introduce a destination-based tax base attribution, I would still argue for individual states to move towards assigning the tax base geographically to the market state as it would likely boost domestic competitiveness, attracting investment and employment, and driving economic growth as a consequence. As said, *"states assigning relatively greater weight to the sales factor (versus payroll and property) will be a more attractive place to locate the property and payroll for business enterprises that produce within that state and export to another states (the tax burden of those firms within the jurisdiction is reduced), whilst the tax burden of firms that produce in other states and import into that state is increased."*[1924]

Moreover, as said, if one country would move to a destination-based corporate tax system, particularly if that would be a major producing country, others would likely follow suit. That also is *"[b]ecause of the widespread belief that imposing taxes on imports and exempting exports boosts national competitiveness and reduces trade deficits."*[1925] Exemplary for the 'built-in incentive' for introducing sales-only apportionment is the internationally widespread adoption of destination-based value added tax systems since the 1960s. It may be argued that this *"provides a good example of how tax innovations can spread without a coordinating supranational agency or world tax organization, simply on the basis of countries' perception of their self-interest."*[1926]

Analogous to the trends in US state income taxation, the end-result would likely be a worldwide adoption of sales-based corporate tax systems. Interestingly, the equilibrium reached would be identical to a transformation to destination based taxing systems under an internationally coordinated approach. The outcome would be an international tax regime providing for a globally efficient allocation of resources, i.e., a taxing system which fits the reality of the global economy. The downside of relying on unilateral activism, however, is the

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Directorate-General Taxation & Customs Union Working Paper 2006:9, at 56-57, and Marcel Gérard, 'Multijurisdictional Firms and Governments' Strategies under Alternative Tax Designs', *CESifo Working Paper* 2005:1527.

[1919] See Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 14.

[1920] *Ibidem*, at 12.

[1921] See e.g., Vito Tanzi, 'Is there a need for a World Tax Organization?', in Assaf Razin et al (eds.),*The economics of globalization: policy perspectives from public economics*, Cambridge University Press, 1999, at 173-186. See for a comparison also Jack M. Mintz, 'The Role of Allocation in a Globalized Corporate Income Tax', *International Monetary Fund Working Paper*, WP/98/134, 1998, at Section VI.

[1922] See Reuven S. Avi-Yonah, 'Slicing the Shadow: A Proposal for Updating U.S. International Taxation', 58 *Tax Notes* 1511 (15 March 1993).

[1923] *Ibidem*, at 21.

[1924] See Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 56.

[1925] See Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 13.

[1926] Ibidem, at 13.

creation of double (non-)taxation issues in the transitional period. Therefore, international coordination, in my view, would be first-best.[1927]

As regards the revenue effects, a transformation from an origin-based to a destination-based system may entail a redistribution of tax revenues across countries. Matters would be hard, if not impossible to predict, though, as the distributional effects would depend on various future behavioral effects, both from the perspectives of the multinationals and the taxing jurisdictions involved.[1928] What can be said though is that the question of which countries would gain and which would lose seems to depend on the corporate sales to corporate income ratios, ceteris paribus. *"The current tax-haven countries would likely experience large reductions in revenues. (…) In general, with the adoption of FA, high-tax countries would likely gain revenue at the expense of low-tax countries because high-tax countries tend to have higher shares of local corporate sales relative to corporate income."*[1929]

6.4.5.3 The effects of currency exchange results under the advocated system

One aspect that has not yet been assessed in this study is the impact of currency exchange rate mutations and interest rate mutations on the operation of the advocated system under a destination based sales only apportionment mechanism. The effects of currency exchange rates on formulary systems have occasionally been assessed in the literature; that is, in the presence of a common return to equity-based tax base definition.[1930] However, to my knowledge, matters have not yet been looked into as regards the combined effects of mutations of currency exchange rates and interest rates where it involves a destination-based division of firm rents for tax purposes. That is, a formulary approach in the presence of a tax base definition that makes use of an allowance for corporate equity ('ACE'). Further, under the advocated system, double tax relief would be granted by reference of a credit for the domestic tax that is attributable to the foreign income, i.e., the Dutch-style tax exemption mechanism that has been advocated in Chapter 3.

Perhaps it is worthy to scrutinize at this place the effects of currency exchange rate mutations under such a taxation model. To my knowledge, this study is the first to perform such an assessment. Interestingly, an assessment of the advocated system reveals that it seems that it would operate neutral in regards to the allocation of firm inputs, also in the presence of movements in currency and exchange rates. Accordingly, the system would not distort investment location decisions, even in the presence of exchange rate and interest rate mutations. That, at least, is the hypothesis.

[1927] It has been argued in the literature that a destination based direct tax system would infringe WTO laws, as the tax system would promote exports and could therefore be considered to constitute an export subsidy. See Charles E. McLure Jr. et al, 'Does Sales-Only Apportionment Violate International Trade Rules?', 96 *Tax Notes* 1513 (9 September 2002). Others argue that such a system is likely to be compatible with current WTO obligations (or, if not, the WTO agreements could be renegotiated). See Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at section 4.2.6, at 25: *"It can be argued that the formula is not explicitly contingent on export performance, and that it serves only as a means for allocating the income tax base among jurisdictions, as opposed to exempting transactions that would otherwise be taxable (as in a VAT). No WTO complaint has been filed against the United States on the state formulas, even though state taxes are subject to WTO constraints."*

[1928] The available literature is ambiguous on this matter. It has been argued that revenue effects are 'not a big issue, in the aggregate' and 'relatively insensitive', see Steven M. Sheffrin et al, 'Alternative Divisions of the Tax Base: How Much is at Stake?', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 192, at 208, and Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 282. Others, however, predict significant distributional effects, see Michael P. Devereux et al, 'The effects of EU Formula Apportionment on Corporate Tax Revenues', *Oxford University Centre for Business Taxation Working Paper* 2007:06.

[1929] Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 25.

[1930] See for instance Benjamin F. Miller, 'Worldwide Unitary Combination: The California Practice', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (1984) 132, at 152-153, and Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 261-262.

The effects of movements in currency exchange rates and interest rates may perhaps be appropriately explained by means of some numerical examples adhering to a 'Base Case' environment and a 'Test Case' environment. The Base Case sets the scene: no interest rate and currency exchange rate mutations arise during the taxing period. Interest rate and currency exchange rate mutations are introduced in the Test Case. The movements in the rates in the Test Case relative to those in the Base Case are deduced by reference to the assumption of interest rate parity theory to hold.[1931] Interest rate parity theory suggests that the interest rate at a certain time in a given country (Country A) equals the interest rate in a given foreign country (Country B) plus/minus the expected rate of depreciation/appreciation of the currency of the first-mentioned country (Country A) over a given period. The intuition underlying interest rate parity theory is that in a perfect capital market, a risk-averse investor would be indifferent as to the available interest rates on deposits in countries because the exchange rates between those countries are expected to adjust such that the deposit returns are equal.

Let us assume that the following scenarios apply. Notably, all currency exchange rates and interest rates are a given, except for the dollar interest rate in the Test Case environment; this rate is deduced by applying interest rate parity theory (figs. 83 and 84).

Fig. 83. Base Case environment: no mutations in currency exchange rate and interest rate

T0: Jan1. Y01	*€/$ exch. rate*	*Int. rate T0-T1*	*€/$ exch. rate*	*T1: 31 Dec. Y 01*
Investment (equity financed) (given)	*1/1 spot rate (given)*	*(given)*	*31/12 spot rate 1/1 forward rate (given)*	*Investment return (return to equity) (deduced)*
€1,000.00	1.00	*** 1.04 (4%)**	1.00	**€1,040.00**
$1,250.00	1.25	*** 1.04 (4%)**	1.25	**$1,300.00**

Fig. 84. Test Case environment: mutations in currency exchange rate and interest rate

T0: Jan1. Y01	*€/$ exch. rate*	*Int. rate T0-T1*	*€/$ exch. rate*	*T1: 31 Dec. Y 01*
Investment (equity financed) (given)	*1/1 spot rate (given)*	*(€ rate given) ($ rate deduced)*	*31/12 spot rate 1/1 forward rate (given)*	*Investment return (return to equity) (deduced)*
€1,000.00	1	*** 1.02 (2%)**	1	**€1,020.00**
$1,250.00	1.25	**** 1,0608 (6.08%)***[1932]	1.30	**$1,326.00**

To assess the effects of the advocated system in the Base Case and Test Case environments in a numerical example, please let us return to the investment of our fictitious multinational Ben Johnson Dinghy Selling Company. Let us assume that Johnson is operational in two countries, selling dinghies in Country A and Country B. Country A uses the euro (€), Country B uses the US Dollar ($).

[1931] See on interest rate parity, John M. Keynes, *A tract on monetary reform* (1924), Robert Z. Aliber, 'The Interest Rate Parity Theorem: A Reinterpretation', 81 *Journal of Political Economy* 1451 (1973), at 1451-1459, Pierre-Alexis Cosandier et al, 'Interest Rate Parity Tests; Switzerland and some Major Western Countries', 5 *Journal of Banking and Finance* 187 (1981), at 187-200, as well as Alex Luiz Ferreira et al, 'Does the real interest rate parity hypothesis hold? Evidence for developed and emerging markets', 26 *Journal of International Monetary and Finance* 364 (2007), at 364-382. To the extent that interest rate parity theory holds, the dollar ($) return on dollar ($) deposits equals the euro (€) return on (€) deposits multiplied with the following fraction: $forward\ rate\ €:\$\ /spot\ rate\ €:\$$. $(1 + i_\$) = (1 + i_€) * (F/S)$.

[1932] 1,000 * 1,02 = 1,020.00. 1,020 * 1.30 = 1,326.00. $^{1,326}/_{1,250}$ = *1.0608*. 1,250 * 1.0608 = 1,326.00. $^{1,326}/_{1.30}$ = 1,020.00. $^{1,020}/_{1.02}$ = 1,000.00. It is noted that in a real-world environment today's forward rates and future spot rates are not identical. That would imply that future spot rates could be forecasted. And that, of course, is impossible as future developments in the capital markets cannot be predicted. Nevertheless, these rates are put on par for the purpose of the analysis for the following reason. A differential between today's forward rate and the future spot rate – seen from a hindsight perspective – is the consequence of a market development rather than taxation. For the matter being analytically separate from taxation, it allows me to analytically exclude the implications of future market developments from the analysis. The point made is that movements in currency and exchange rates would not be affected under the advocated tax system. To the extent that future rates would diverge from today's forward rate, such a differential would be appreciated accordingly by the tax implications under the advocated system. A differential in the forward rate and future spot rate involved would imply a corresponding differential in the tax effect involved. And so would a putting of the rates on par, allowing the analytical simplification for the current assessment. As the differential is not caused by taxation in a no-tax environment, it is not necessary to include it in the analysis if taxation is put into the equation. It would merely complex matters rather than alter things substantially.

At a certain moment in time (T0), Johnson undertakes an equity investment in a dinghy sales venture. Let us assume that Johnson's inputs account for €1,000. Accordingly:

- Johnson's inputs for tax purposes from the perspective of Country A account for €1,000.
- Johnson's inputs for tax purposes from the perspective of Country B account for $1,250 (given spot rate 1:1.25).
- Notably, the investment location is irrelevant for tax purposes, since the advocated system divides tax base by reference to sales at destination. Further, if Johnson were to invest in diverging currencies, matters would not analytically alter either.[1933]

At a certain later moment in time (T1), Johnson sells its product in Countries A and B to customers Y and Z (investment return). Let us assume that Johnson's outputs are as follows:

- Johnson's outputs on T1 in Country A equal €1,080 (sales to customer Y);
- Johnson's outputs on T1 in Country B equal $1,350 (sales to customer Z).

Further, the given tax rate in Country A equals 25%, the Country B tax rate is 30% (rate disparity), respectively 25% (rate parity).

The effects of currency exchange rate and interest rate mutations in the system may be illustrated best by reference to four scenarios, the first two of which refer to the Base Case environment (no mutations), the latter two to the Test Case environment (mutations).

- The first scenario (no mutations) and third scenario (mutations) set forth the effects of the tax system if no ACE applies, i.e., the effects under the application of a system that makes use of a common return to equity-based corporate income tax base definition.
- The second scenario (no mutations) and fourth scenario (mutations) set forth the effects of the tax system where an ACE applies for tax base calculation purposes, i.e., the effects under the application of the advocated tax system, taxing firm rents at destination. Accordingly, the second and fourth scenario system addresses the effects under the advocated system in the absence and presence of mutations in currency exchange rates and interest rates.

This accordingly produces the following four outcomes:

1) Base Case, no mutations, no ACE (conventional corporate income tax basis) – fig. 85;
2) Base Case, no mutations, ACE (rents as tax base, i.e., the benchmark) – fig. 86;
3) Test Case, mutations, no ACE (conventional corporate income tax basis) – fig. 87;
4) Test Case, mutations, ACE (rents as tax base, i.e., the advocated system; testing hypothesis) – fig. 88.

Fig. 85. Scenario 1) Base Case: no mutations in interest rate and currency exchange rate; no ACE

No ACE ***No mutations – assumption a)***	*Country A (€)* *(Tax rate: 25%)*	*Country B ($)* *(Tax rate: 30%)*	*Country B ($)* *(Tax rate 25%)*
Worldwide Inputs (I)	1,000.00	1,250.00	1,250.00
Worldwide Outputs (O)	2,160.00[1934]	2,700.00[1935]	2,700.00[1936]
Worldwide Profits (P)	1,160.00[1937]	1,450.00[1938]	1,450.00[1939]

[1933] Would Johnson's inputs, for instance, amount to €400 and $750, the inputs for tax purposes from the perspective of Country A would equal €1,000. That is, since $750 converts into €600, at the given €/$ currency exchange rate of 1: 1.25 on T0, producing the Country A inputs of €400 + €600 = €1,000.00. The inputs for tax purposes from the perspective of Country B would equal $1,250. That is, since €400 converts into $500, at the given €/$ currency exchange rate of 1: 1.25 on T0, producing the Country B inputs of $750 + $500 = $1,250.00.

[1934] $1{,}080 + {}^{1{,}350}/_{1.25} = 2{,}160.00$.

[1935] 1,350 + 1,080 * 1.25 = 2,700.00.

[1936] 1,350 + 1,080 * 1.25 = 2,700.00.

[1937] 2,160.00 -/- 1,000.00 = 1,160.00.

(P = O -/- I)			
Tax (T) *(Tax on worldwide profits; T = P*T)*	290.00[1940]	435.00[1941]	362.50[1942]
Double tax relief Country A (DTR^A) $(DTR\ A = \left(\frac{Sales^B}{Sales^{A+B}}\right) * T^A)$	145.00[1943]	n/a	n/a
Double tax relief Country B (DTR^B) $(DTR\ B = \left(\frac{Sales^A}{Sales^{B+A}}\right) * T^B)$	n/a	217.50[1944]	181.25[1945]
Tax Payable *(TP = T -/- double tax relief)*	€145.00[1946]	$217.50[1947]	$181.25 (€145.00)[1948]

The calculations in this table reveal that in the Base Case environment (no mutations) the system (corporate income tax basis) produces a 50-50 allocation of Johnson's worldwide profit at destination. The system implicitly allocates Johnson's costs on a 50-50 basis also, i.e., as the cost allocation effectively follows the sales allocation. The system allocates profit at destination.

Johnson's sales in Country A worth €1,080.00 correspond with 50% of Johnson's worldwide sales worth €2,160.00, i.e., from the perspective of Country A. The tax payable in Country A equals €145.00. This produces an effective average tax rate of 25% on 50% of Johnson's profit attributed to Country A territories by reference to Johnson's profits that are destined for Country A.

Johnson's sales in Country B worth $1,350.00 correspond with 50% of Johnson's worldwide sales worth $2,700.00, i.e., from the perspective of Country B. The tax payable in Country B respectively equals $217.50 (30% tax rate) and $181.25 (25% tax rate). This produces an effective average tax rate of, respectively 30% and 25% on 50% of Johnson's profit attributed to Country B territories by reference to Johnson's profits that are destined for Country B.

Fig. 86. Scenario 2) Base Case: no mutations in interest rate and currency exchange rate; ACE

ACE ***No mutations – assumption a)***	*Country A (€)* *(Tax rate: 25%)*	*Country B ($)* *(Tax rate: 30%)*	*Country B ($)* *(Tax rate 25%)*
Worldwide Inputs (I)	1,040.00[1949]	1,300.00[1950]	1,300.00[1951]
Worldwide Outputs (O)	2,160.00[1952]	2,700.00[1953]	2,700.00[1954]
Worldwide Rents (R) *(R = O -/- I)*	1,120.00[1955]	1,400.00[1956]	1,400.00[1957]
Tax (T) *(Tax on worldwide rents; T = R*T)*	280.00[1958]	420.00[1959]	350.00[1960]

[1938] 2,700.00 -/- 1,250.00 = 1,450.00.
[1939] 2,700.00 -/- 1,250.00 = 1,450.00.
[1940] 0.25 * 1,160.00 = 290.00.
[1941] 0.30 * 1,450.00 = 435.00.
[1942] 0.25 * 1,450.00 = 362.50.
[1943] $1{,}350/_{1.25}/2{,}160$ * 290 = 145.00.
[1944] $1{,}080 * 1.25\ /_{2{,}700}$ * 435 = 217.50.
[1945] $1{,}080 * 1.25\ /_{2{,}700}$ * 362.50 = 181.25.
[1946] 290 -/- 145 = 145.00.
[1947] 435 -/- 217.50 = 217.50.
[1948] 362.50 -/- 181.25 = 181.25. Notably, $181.25, i.e., the tax payable in country B converts into €145, i.e., the double tax relief amount by country A: $181.25/_{1.25}$ = 145.00.
[1949] 1,000 * 1,04 = 1,040.00.
[1950] 1,250 * 1,04 = 1,300.00.
[1951] 1,250 * 1,04 = 1,300.00.
[1952] 1,080 + $1{,}350/_{1.25}$ = 2,160.00.
[1953] 1,350 + 1,080 * 1.25 = 2,700.00.
[1954] 1,350 + 1,080 * 1.25 = 2,700.00.
[1955] 2,160 -/- 1,040 = 1,120.00.
[1956] 2,700 -/- 1,300 = 1,400.00
[1957] 2,700 -/- 1,300 = 1,400.00
[1958] 0.25 * 1,120 = 280.00.
[1959] 0.30 * 1,400 = 420.00.
[1960] 0.25 * 1,400 = 350.00.

Double tax relief Country A (DTR^A) *($DTR\ A = \left(\frac{Sales^B}{Sales^{A+B}}\right) * T^A$)*	140.00[1961]	n/a	n/a
Double tax relief Country B (DTR^B) *($DTR\ B = \left(\frac{Sales^A}{Sales^{B+A}}\right) * T^B$)*	n/a	210.00[1962]	175.00[1963]
Tax Payable *(TP = T -/- double tax relief)*	**€140.00[1964]**	**$210.00[1965]**	**$175.00** (€140.00)[1966]

The calculations in this table tell us that in the Base Case environment (no mutations) the system (ACE-basis) produces a 50-50 allocation of Johnson's worldwide rents at destination. The introduction of the ACE does not affect the allocation key. Again, the system also implicitly allocates Johnson's costs on a 50-50 basis, i.e., as the cost allocation effectively follows the sales allocation. The same holds for the allocation of the ACE. The system allocates profit at destination.

Johnson's sales in Country A, worth €1,080.00 correspond with 50% of Johnson's worldwide sales worth €2,160.00, i.e., from the perspective of Country A .The tax payable in Country A equals €140.00. This produces an effective average tax rate of 25% on 50% of Johnson's rents attributed to Country A territories by reference to Johnson's rents that are destined for Country A. The revenue decreases with €5.00 relative to the revenue in scenario 1).[1967] This effect has been caused by the introduction of the ACE into the system. The relative increase of the inputs for tax purposes of €40.00 brought about by the ACE produces the €5.00 revenue decrease.[1968]

Johnson's sales in Country B worth $1,350.00 correspond with 50% of Johnson's worldwide sales worth $2,700.00, i.e., from the perspective of Country B. The tax payable in Country B respectively equals $210.00 (30% tax rate) and $175.00 (25% tax rate). This produces an effective average tax rate of respectively 30% and 25% on 50% of Johnson's rents attributed to Country B territories by reference to Johnson's profits that are destined for Country B. The revenue decreases respectively by $7.50 and $6.25 relative to the revenue in scenario 1).[1969] This effect has been caused by the introduction of the ACE into the system. The relative increase of the inputs for tax purposes of $50.00 brought about by the ACE produces the respective $7.50 and $6.25 revenue decreases.[1970]

Fig. 87. Scenario 3) Test Case: no ACE; mutations in interest rate and currency exchange rate.

No ACE ***Mutations – assumption b)***	*Country A (€)* *(Tax rate: 25%)*	*Country B ($)* *(Tax rate: 30%)*	*Country B ($)* *(Tax rate 25%)*
Worldwide Inputs (I)	1,000.00	1,300.00[1971]	1,300.00[1972]
Worldwide Outputs (O)	2,118.46[1973]	2,754.00[1974]	2,754.00[1975]
Worldwide Profits (P)	1,118.46[1976]	1,454.00[1977]	1,454.00[1978]

[1961] $1{,}350/_{1.25}/2{,}160$ * 280 = 140.00.
[1962] $1{,}080 * 1.25/_{2{,}700}$ * 420 = 210.00.
[1963] $1{,}080 * 1.25/_{2{,}700}$ * 350 = 175.00.
[1964] 280 -/- 140 = 140.00.
[1965] 420 -/- 210 = 210.00.
[1966] 350 -/- 175 = 175.00. Notably, $175.00, i.e., the tax payable in country B converts into €140, i.e., the double tax relief amount by country A: $175.00/_{1.25}$ = 140.00.
[1967] 145 -/- 140 = 5.00
[1968] (1,040 -/- 1,000) * 0.50 * 0.25 = 5.00
[1969] Country B (30% tax rate); 217.50 -/- 210.00 = 7.50. Country B (25% tax rate); 181.25 -/- 175.00 = 6.25.
[1970] Country B (30% tax rate); (1,300 -/- 1,250) * 0.50 * 0.30 = 7.50. Country B (25% tax rate); (1,300 -/- 1,250) * 0.50 * 0.30 = 6.25.
[1971] 1,000 * 1,30 = 1,300.00, i.e., inputs amount of €1,000 multiplied with €/$ forward rate of 1/1.30 on January 1, FY01.
[1972] 1,000 * 1,30 = 1,300.00, i.e., inputs amount of €1,000 multiplied with €/$ forward rate of 1/1.30 on January 1, FY01.
[1973] 1,080 + $1{,}350/_{1.30}$ = 2,118.46.
[1974] 1,350 + 1,080 * 1.30 = 2,754.00.
[1975] 1,350 + 1,080 * 1.30 = 2,754.00.
[1976] 2,118.46 -/- 1,000 = 1,118.46.
[1977] 2,754 -/- 1,300 = 1,454.00.

(P = O -/- I)			
Tax (T) *(Tax on worldwide profits; T = P*T)*	279.62[1979]	436.20[1980]	363.50[1981]
Double tax relief Country A (DTR^A) *($DTR\ A = \left(\frac{Sales^B}{Sales^{A+B}}\right) * T^A$)*	**137.07**[1982]	n/a	n/a
Double tax relief Country B (DTR^B) *($DTR\ B = \left(\frac{Sales^A}{Sales^{B+A}}\right) * T^B$)*	n/a	222.38[1983]	185.31[1984]
Tax Payable *(TP = T -/- double tax relief)*	€142.55[1985]	$213.82[1986]	$178.19 (**€137.07**)[1987]

The calculations in this table reveal that in the Test Case environment (mutations) the system (corporate income tax-basis) produces an allocation key which favors the taxing jurisdiction where the currency rate strengthens (here, Country A). In the current example, the system produces a B-A tax base allocation of 49.50-50.50, favoring Country A over Country B. This effect has also been recognized in the literature, and is considered problematic. *"The fact that the income attributed to those operations would rise when the exchange rate strengthens runs counter to the normal presumption that a stronger exchange rate makes it more difficult to export (and to compete with imports), creating downward pressure on profits."*[1988] The cost allocation still implicitly and effectively follows the sales allocation.

Johnson's sales in Country A worth €1,080.00 correspond with 50.50% of Johnson's worldwide sales worth €2,118.46, i.e., from the perspective of Country A .The tax payable in Country A equals €142.55. The revenue decreases with €2.45 relative to the revenue in scenario 1).[1989] This effect has been caused by the value decrease of the $ relative to the €. The $ sales have become less profitable to the firm. This effect is not compensated by the shift in the profit allocation in favor of Country A.

Johnson's sales in Country B worth $1,350.00 correspond with 49.50% of Johnson's worldwide sales worth $2,727.00, i.e., from the perspective of Country B. The tax payable in Country B respectively equals $213.82 (30% tax rate) and $178.19 (25% tax rate). The revenue decreases respectively by $3.68 and $3.06 relative to the revenue in scenario 1.[1990] This effect has been caused by the value decrease of the $ relative to the €. The € inputs have increased rendering the operations less profitable to the firm. This effect is not compensated by the shift in the implicit costs allocation in favor of Country B.

Notably, in the tax rate parity scenario where both Country A and Country B apply a 25% tax rate, the calculations show that *"fluctuations in exchange rates would affect only the division of the tax base."*[1991] Viz., the calculations show that the tax payable in Country B of $178.19

[1978] 2,754 -/- 1,300 = 1,454.00.
[1979] 0.25 * 1,118.46 = 279.62.
[1980] 0.30 * 1,454.00 = 436.20.
[1981] 0.25 * 1,454.00 = 363.50.
[1982] $1{,}350/_{1.30}/2{,}118.46$ * 279.62 = 137.07.
[1983] $1{,}080 * 1.30\ /_{2{,}754}$ * 436.20 = 222.38.
[1984] $1{,}080 * 1.30\ /_{2{,}754}$ * 363.50 = 185.31.
[1985] 279.62-/- 137.07 = 142.55.
[1986] 436.20 -/- 222.38 = 213.82.
[1987] 363.50 -/- 185.31= 178.19. Notably, $178.19, i.e., the tax payable in country B converts into €137.07, i.e., the double tax relief granted by country A: $178.19/_{1.30}$ = 137.07. Notably, $178.19/_{1.25}$ = 142.55.
[1988] See Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 261-262, and J.T. van Egdom RA, *Verrekenprijzen; de verdeling van de winst van een multinational* (2011), at 22 (footnote 45).
[1989] 145.00 -/- 142.55 = 2.45. Notably, revenue would have increased if the $ would have increased in value – as that would have produced more valuable $ outputs.
[1990] Country B (30% tax rate); 217.50 -/- 213.82= 3.68. Country B (25% tax rate); 181.25 -/- 178.19 = 3.06. Notably, revenue would have increased if the $ would have increased in value (as that would have produced cheaper € inputs).
[1991] See Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 261-262.

converts into €137.07, i.e., the double tax relief amount granted by Country A (the opposite also holds true). The table also shows that to the extent that *"tax rates differ, aggregate tax liability would also be affected."*[1992]

The tax effects in this scenario as caused by the movement in the currency exchange rate provides a tax-induced incentive at the micro-level. It incentivizes the firm to speculate at the inputs side and increase its production in Country B and reduces its production in Country A. The system also provides an incentive for firms to speculate at the output-side and to increase its selling in Country A and reduce its selling in Country B. Alternatively, the system forces multinationals to engage in tax-induced hedging transactions to insure themselves against the risks of upward and downward movements in the tax burdens they face. At the macro-level, it provides a tax-induced monetary policy incentive for countries to reduce their currency rate to attract business and promote exports. The scenario 3) system accordingly is not neutral as regards the geographic location of firm inputs.

Fig. 88. Scenario 4) Test Case: ACE; mutations in interest rate and currency exchange rate.

ACE ***Mutations – assumption b)***	*Country A (€)* *(Tax rate: 25%)*	*Country B ($)* *(Tax rate: 30%)*	*Country B ($)* *(Tax rate 25%)*
Worldwide Inputs (I)	1,020[1993]	1,326.00[1994]	1,326.00[1995]
Worldwide Outputs (O)	2,118.46[1996]	2,754.00[1997]	2,754.00[1998]
Worldwide Rents (R) *(R = O -/- I)*	1,098.46[1999]	1,428.00[2000]	1,428.00[2001]
Tax (T) *(Tax on worldwide rents; T = R*T)*	274.62[2002]	428.40[2003]	357.00[2004]
Double tax relief Country A (DTR^A) *($DTR\ A = \left(\frac{Sales^B}{Sales^{A+B}}\right) * T^A$)*	134.62[2005]	n/a	n/a
Double tax relief Country B (DTR^B) *($DTR\ B = \left(\frac{Sales^A}{Sales^{B+A}}\right) * T^B$)*	n/a	218.40[2006]	182.00[2007]
Tax Payable *(TP = T -/- double tax relief)*	**€140.00**[2008]	**$210.00**[2009]	**$175.00** (€134.62)[2010]

The calculations in this table, i.e., the effects under the advocated system, show that in the Test Case environment (mutations), the system (ACE basis) produces an allocation key which, indeed, favors the taxing jurisdiction where the currency rate strengthens (here, Country A). In the current example, the system produces an A-B tax base allocation percentage of 50.50-49.50, favoring Country A over Country B. This effect is identical to the allocation key in scenario 3). However, contrary to the outcomes in scenario 3) in terms of tax payable and revenue allocation, here the outcomes do not differentiate from those in scenario 2). The amounts of tax payable in scenario 2) 'Base Case: no mutations; ACE', and scenario 4) 'Test Case: mutations; ACE' are identical. The issues in scenario 3) accordingly do not

[1992] *Ibidem*.
[1993] 1,000 * 1,02 = 1,020.00.
[1994] 1,250 * 1,0608 = 1,326.00.
[1995] 1,250 * 1,0608 = 1,326.00.
[1996] 1,080 + $^{1,350}/_{1.30}$ = 2,118.46.
[1997] 1,350 + 1,080*1.30 = 2,754.00.
[1998] 1,350 + 1,080*1.30 = 2,754.00.
[1999] 2,118.46 -/- 1,020 = 1,098.46.
[2000] 1,326 -/- 2,754 = 1,428.00.
[2001] 1,326 -/- 2,754 = 1,428.00.
[2002] 0.25 * 1,098.46 = 274.62
[2003] 0.30 * 1,428 = 428.40.
[2004] 0.25 * 1,428 = 357.00.
[2005] $^{1,350}/_{1.30}/2{,}118.46$ * 274.62 = 134.62.
[2006] $1{,}080 * {}^{1.30}/_{2{,}754}$ * 428.40 = 218.40.
[2007] $1{,}080 * {}^{1.30}/_{2{,}754}$ * 357.00 = 182.00.
[2008] 274.62 -/- 134.62 = 140.00.
[2009] 428.40 -/- 218.40 = 210.00.
[2010] 357.00 -/- 182.00 = 175.00. Notably, $175.00, i.e., the tax payable in country B converts into €140.00, i.e., the double tax relief granted by country A: $^{175.00}/_{1.30}$ = 134.62. Notably, $^{175.00}/_{1.25}$ = 140.00.

arise in scenario 4). The cost allocation still implicitly and effectively follows the sales allocation.

Why are the outcomes identical to those in scenario 2)? Johnson's sales in Country A worth €1,080.00 correspond with 50.50% of Johnson's worldwide sales worth €2,118.46, i.e., from the perspective of Country A .The tax payable in Country A equals €140.00. The amount of tax is accordingly identical to that in scenario 2). This effect is caused by the advocated system's property that *it taxes rents rather than profits*. The value decrease of the $ relative to the € has been compensated by a converse decrease of the $ interest rate relative to the € interest rate. The currency exchange rate mutation and the converse interest rate mutation have cancelled each other out, thereby, in this respect, producing a neutral system. The neutrality has been upheld due to the combination of worldwide taxation and a fractional approach towards providing double tax relief.

Johnson's sales in Country B worth $1,350.00 correspond with 49.50% of Johnson's worldwide sales worth $2,727.00, i.e., from the perspective of Country B. The tax payable in Country B, respectively, equals $210.00 (30% tax rate) and $175.00 (25% tax rate). The revenue accordingly is identical to those in scenario 2). This effect again is caused by the advocated system's property of taxing rents rather than nominal returns to equity. The value decrease of the $relative to the € has been compensated by a converse decrease of the $ interest rate relative to the € interest rate. The currency exchange rate mutation and the converse interest rate mutation have cancelled each other out, thereby, in this respect, producing a neutral system. The neutrality, as said, has been upheld due to the combination of worldwide taxation and a fractional approach towards the provision of double tax relief.

An assessment of the advocated system reveals that it would operate neutrally as regards the allocation of firm inputs. The system would not tax-distort investment location decisions, even in the presence of mutations in currency exchange rates and interest rates. The problematic effects of currency exchange rate mutations in formulary apportionment recognized in the literature,[2011] are not a consequence of the profit division mechanism used. It is the consequence of the use of a conventional return to equity tax base definition rather than an economic rents-oriented tax base definition. In addition, interest rate parity is not affected by the advocated tax system, as the model taxes worldwide rents and provides double tax relief for foreign income by reference to a sales basis fractional approach. The system promotes production factor neutrality accordingly.

6.4.5.4 Simplifying matters: multiplying firm's worldwide rents with domestic sales over worldwide sales ratio

The advocated system can be further simplified mathematically without losing these essential efficiency enhancing properties.[2012] The simplification may be achieved by calculating the tax payable by reference to the tax on worldwide rents as multiplied with a domestic sales over worldwide sales ratio:

$$\textit{Tax Payable} = \textit{Tax Rate} * \textit{Firm's Worldwide Rents} * {}^{Domestic\ Sales}/_{Worldwide\ Sales}$$

In a schedule (fig. 89):

Fig. 89. Scenario 4[A]) Test Case: ACE; mutations in interest rate and currency exchange rate / simplified

ACE ***Mutations – assumption b)***	*Country A (€)* *(Tax rate: 25%)*	*Country B ($)* *(Tax rate: 30%)*	*Country B ($)* *(Tax rate 25%)*

[2011] See Charles E. McLure Jr. et al, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 243, at 261-262.
[2012] I would like to thank professor A.J.A. (Ton) Stevens for the insight.

Worldwide Inputs (I)	1,020[2013]	1,326.00[2014]	1,326.00[2015]
Worldwide Outputs (O)	2,118.46[2016]	2,754.00[2017]	2,754.00[2018]
Worldwide Rents (R) *(R = O -/- I)*	1,098.46[2019]	1,428.00[2020]	1,428.00[2021]
Tax (T) *(Tax on worldwide rents; T = R*T)*	274.62[2022]	428.40[2023]	357.00[2024]
Tax Payable Country A *($TP_A = T_A * \frac{Sales^A}{Sales^{A+B}}$)*	**€140.00**[2025]	n/a	n/a
Tax Payable Country B *$TP_B = T_B * \frac{Sales^B}{Sales^{B+A}}$*	n/a	**$210.00**[2026]	**$175.00**[2027]

The simplification relative to the 'worldwide taxation minus double tax relief approach' as consistently utilized until this point of the analysis, has become available, since the complications addressed in Chapter 3 involving cross-border loss offset (sections 3.4.2 and 3.5.3.2) and intra-firm transfers (sections 3.4.3 and 3.5.3.3) have been resolved throughout the course of this study via other means. Cross-border loss offset issues cease to arise under the advocated system in consequence of the advocated worldwide tax-consolidation (addressed in Chapter 4). Issues involving intra-firm transfers cease to arise under the advocated system as a consequence of the replacement of SA/ALS by a 'sales only apportionment' for geographic tax base attribution purposes (addressed in the current chapter).

It accordingly suffices to calculate the tax payable by multiplying the tax on the firm's worldwide rents against its domestic sales over worldwide sales ratio. The system notably still is a worldwide system using a fractional approach to establish the tax payable in the respective taxing states involved. The reason for this is that the system needs to properly address the cross-border differentials in currency exchange rates and interest rates. A 'territorial' destination-based corporate tax would fail to serve that purpose.

In consequence the advocated system adheres to a two-step approach to calculate the tax payable whereby (1) the firm's worldwide rents are viewed and (2) multiplied with a domestic sales over worldwide sales ratio. That is, to arrive at an equitable and efficient slicing of the global tax pie.

6.4.6 Rate coordination, revenue sharing? Perhaps not

Section 6.4.5.1 ends with the remark that economic efficiencies would remain to hold up under a destination-based division of profit to a certain extent, if tax rate differentials remain present. Ceteris paribus, firms will be incentivized to sell their products in the comparatively lower taxing jurisdiction first. Customers will be incentivized to buy products in the comparatively lower tax jurisdiction. Similar effects can be seen in European Union value

[2013] 1,000 * 1,02 = 1,020.00.
[2014] 1,250 * 1,0608 = 1,326.00.
[2015] 1,250 * 1,0608 = 1,326.00.
[2016] 1,080 + $^{1,350}/_{1.30}$ = 2,118.46.
[2017] 1,350 + 1,080*1.30 = 2,754.00.
[2018] 1,350 + 1,080*1.30 = 2,754.00.
[2019] 2,118.46 -/- 1,020 = 1,098.46.
[2020] 1,326 -/- 2,754 = 1,428.00.
[2021] 1,326 -/- 2,754 = 1,428.00.
[2022] 0.25 * 1,098.46 = 274.62
[2023] 0.30 * 1,428 = 428.40.
[2024] 0.25 * 1,428 = 357.00.
[2025] 274.62 * $^{1,080 * 1.30}/_{2,754}$ = 140.00.
[2026] 428.40 * $^{1,350}/_{1.30}/2{,}118.46$ = 210.00.
[2027] 357.00 * $^{1,350}/_{1.30}/2{,}118.46$ = 175.00.

added taxation, particularly near international (tax) borders. In value added taxation, the matter is sometimes referred to as 'cross-border shopping'.[2028]

Only a fully harmonized worldwide tax system applying identical tax rates would overcome these effects.[2029] *"[A]s long as each company faces the same effective corporate tax rate on all its investments, then location decisions will not be distorted."*[2030] Indeed, profit shifting incentives would fully disappear under a system where even the tax rate disparity is resolved. In the presence of identical effective tax rates across tax borders, it would not make sense to seek to shift corporate profit for tax reasons. By inference, location distortions would be mitigated if and to the extent that rate bandwidths or minimum rates would be introduced, e.g., on a global level, or alternatively, on regional levels (EU, NAFTA).[2031] Worth noting is that European Parliament envisages a future possibility of tax rate coordination within the European Union under the CCCTB.[2032]

Under such circumstances, one may also proceed to share the tax revenue rather than geographically assign the taxable base. That would basically bring about the adoption of a revenue sharing mechanism.[2033] Revenue sharing would conceptually side-step the tax base allocation issue altogether. Namely, the imposition of identical effective tax rates would render moot the necessity to geographically attribute tax base. From a micro-perspective, the cross-border distribution of tax among firms under a tax revenue sharing mechanism would not differ from the cross-border distribution of tax under a tax base allocation mechanism if the effective tax rates across borders are identical. As the tax burdens imposed in both domestic and cross-border scenarios would be identical, inter-taxpayer neutrality issues and inter-taxpayer equity issues would be absent. In the presence of identical effective average tax burdens across borders, the allocation of tax would solely constitute an inter-nation issue. In such a scenario, the distributional issue would arise solely at the macro-level to be dealt with at the governmental level accordingly. The jurisdictions involved may decide to assign the tax revenue, for instance, on the basis of macro-factors such as territorial GDPs, population, et cetera.[2034]

It should be noted that the allocation of tax base by means of macro-factors would produce totally unfair outcomes if the tax rate is not also harmonized. The tax base division in such a

[2028] See e.g. Lucas W. Davis, 'The Effects Of Preferential VAT Rates Near International Borders: Evidence From Mexico', 64 *National Tax Journal* 85, (2011), at 85-104.

[2029] See Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 700, 707 and 716. The similar argument has been used to advocate using uniform formulae in US state taxation, see Bharat Anand et al, 'The weighting game: formula apportionment as an instrument of public policy', 53 *National Tax Journal* 183 (2000), at 183-199, as well as Austan Goolsbee et al, 'Coveting thy neighbor's manufacturing: The dilemma of state income apportionment', 75 *Journal of Public Economics* 125 (2000), at 125-143. See for a comparison Joann M. Weiner, 'Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level', 13 *Tax Notes International* 2113 (23 December 1996) who refers to the investment location distortions that arise under the present non-harmonization of state formulae in the US.

[2030] See Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 706.

[2031] Cf. Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014), at 24-38. For an analysis on regional tax coordination in the South East Asian region, see Adrianto Dwi Nugroho, 'Tickets to Ride: The Race for Preferable CIT Regimes Towards ASEAN Economic Community', 40 *Intertax* 531 (2012, No. 10), at 531-539.

[2032] European Parliament proposed to introduce the possibility for future rate harmonization; See European Parliament legislative resolution of 19 April 2012 on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB) (COM(2011)0121 – C7-0092/2011 – 2011/0058(CNS)), Amendment 10; changes proposed to recital 5a (new). If the CCCTB would apply mandatorily as well, that would effectively introduce a fully centralized 'European Union Company Income Tax' ('EUCIT').

[2033] On revenue sharing, see Thomas Horst, 'A Note on The Optimal Taxation of International Investment Income', 94 *Quarterly Journal of Economics* 793 (1980), at 793-798, Michael P. Devereux, 'Taxation of outbound direct investment: economic principles and tax policy considerations', 24 *Oxford Review of Economic Policy* 698 (2008), at 706, Malcolm Gammie, 'Corporate Taxation in Europe – Paths to a Solution', 4 *British Tax Review* 233 (2001), at 233-249, and Jack M. Mintz, 'The Role of Allocation in a Globalized Corporate Income Tax', *International Monetary Fund Working Paper*, WP/98/134, 1998, at Section III. Revenue sharing has also been suggested in the area of EU-VAT, see, e.g., Kenneth Vyncke et al, 'Towards a Simpler, More Robust and Efficient VAT System by Levying VAT at EU Level', 22 *International VAT Monitor* 242 (2011, No. 4), at 242-248.

[2034] On the assigning of tax revenue on the basis of macro factors, Walter Hellerstein et al, 'Lost in Translation: Contextual Considerations in Evaluating the Relevance of US Experience for the European Commission's Company Taxation Proposals', 58 *Bulletin for international taxation* 86 (2004), at 86-98.

scenario would render completely out of sync with the economic activities that the individual taxable firms perform within the respective taxing jurisdictions. This has also been acknowledged by commentators within the context of the European Union's CCCTB project: *"macro-based apportionment presents the fundamental drawback of disconnecting the real economic activity performed by a company in a country with its tax liability in that country, which conflicts with the very idea of a 'fair' distribution of the tax base. (…) Therefore, a sharing mechanism based on macro factors would require a complementary action at EU level on tax rates (harmonizing tax rates or fixing a bracket of admissible tax rates). Thus, an expert concluded that macro apportionment does not seem a realistic solution for the CCCTB project; it would only have sense in a context of more harmonization of corporate taxation at the EU level, for example a scenario with an EU corporate income tax, which is far beyond the current policy."*[2035] In the presence of tax rate differentials macro-based allocation, therefore, should not be considered a route to be followed.[2036]

The market neutrality that a multilateral coordination of effective tax rates would give rise to, however, comes with a price. A harmonization of tax rates encroaches upon the respective nation state's competence in the area of corporate taxation to individually set its tax policies and to decide on the size of government and the revenue requirements to finance public expenditure. Accordingly, tax rate coordination would basically erode the state's power of the purse in corporate tax. Rate coordination belittles the essence of fiscal sovereignty of the nation state, since, without the power of the purse, a nation state cannot properly function, and perhaps could even be considered not to exist at all.

Tax rate coordination would involve an essential transfer of fiscal autonomy from the nation state to some kind of supranational taxing agency. Worth noting is that, despite the European Parliament's suggestion to the opposite, the Commission has expressed that it cannot accept rate coordination.[2037] It considers that the CCCTB proposal is meant to not touch upon tax rates, for these are a matter inherent in state tax sovereignty, and should be dealt with through domestic legislation accordingly.[2038] It may therefore perhaps not come as a surprise that even the suggestion of rate harmonization encounters serious political resistance in the European Union Member States, due to the substantial transfers of fiscal autonomy to the union it would involve. Rate harmonization seems to give rise to insurmountable sovereignty issues.

It seems that tax rate differentiation needs to be accepted as a given.[2039] But perhaps that should not be considered to pose that big of a conceptual issue at all. As the tax base in the advocated system would be allocated to the market jurisdiction, a relatively immobile tax connection factor, the location distortions may be mitigated significantly – i.e., in comparison

[2035] See Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Working Paper No. 52, *An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB*, Taxud E1 AAG-GR-FF, CCCTB\WP\052\doc\en, Brussels, 27 February 2007, at 3-4 (par. 10-11).

[2036] Cf. Ana Agúndez-Garcia, 'Taxation Papers; The Delineation and Apportionment of an EU Consolidated Tax Base For Multi-Jurisdictional Corporate Income Taxation: A Review Of Issues and Options', *European Commission Directorate-General Taxation & Customs Union Working Paper* 2006:9, at 39-43. Garcia cites Charles McLure, Jr., 'The European Commission's Proposals for Corporate Tax Harmonization', 6 *CESifo Forum* 32 (2005), who argues at 35 that macro-based apportionment could have anomalous effects in the presence of tax rate differentials and should therefore not be considered seriously.

[2037] See Commission Communication on the action taken on opinions and resolutions adopted by Parliament at the April 2012 part-session, (SP(2012)388), 30 May 2012.

[2038] See the Explanatory memorandum to the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS), at section 3.

[2039] That might even include the sovereign entitlement of a taxing jurisdiction involved to decide to not to tax the slice of the pie as attributed to its territories on the basis of the sharing mechanism. The question arises as to how to respond if one of the taxing jurisdictions involved would refrain from taxing the assigned part of the corporate tax base. It should be kept in mind that the attribution takes place by reference to a real economic factor, sales at destination that is. One may think of introducing for instance a (spread) throwback rule or a throwout rule under the failure to meet a subject to tax test. That would have the effect of redistributing the tax base to the other taxing jurisdictions involved which do subject the assigned share of the tax base to an effective tax. Such an approach would encounter some sovereignty issues as it would intrude upon the first-mentioned state's sovereign entitlement to set the tax rate – i.e., including its sovereign entitlement not to subject the business proceeds involved to corporate taxation. Mclure argues *"that factors located in a country that has jurisdiction to tax but chooses not to tax should not be thrown out."* See Charles E. McLure Jr., 'Replacing Separate Accounting and the Arm's Length Principle with Formulary Apportionment', 56 *Bulletin for international taxation* 586 (2002), at 590 (footnote 14).

to the location distortions present in the current international tax regime. This has already been extensively elaborated upon. Further, the maintenance of tax rate disparities would allow nation states to autonomously set their tax policies and uphold their fiscal sovereignties as a consequence of that. Commentators have argued that the allocation of corporate income at destination may ultimately even help governments to pursue the policy objectives their voters desire more independently than they are able to do today, as such a tax base allocation system would take away the *"pressures of tax competition for an increasingly mobile capital"* present in the current system.[2040]

Further, it may be argued that the remaining fiscal competition may very well merely revolve around matters referred to as the 'Tiboutian paradigm' or 'administrative net outputs'.[2041] Tibout's paradigm of tax competition basically suggests that persons choose jurisdictions based on their preferred levels of government services and bear the cost of reduced services if they choose a lower-tax jurisdiction, assuming the perfect mobility of persons and a positive correlation between the level of the corporate tax impost and the level benefits of public goods provided – the benefits principle. The concept of states competing through their administrative net outputs has been suggested by Vogel. [2042] Like Tibout, Vogel also mentions the benefits principle to connect the correlation between tax revenue and government expenditure with the efficiency of the administrative machinery of government. He basically suggests that states would compete over their 'administrative net outputs' as the relative levels of tax revenues and public goods provided would, in the end, be indifferent as to where to locate. Both approaches suggest that regardless of the level of government, the costs of services rendered are borne either way, as a fee paid to the provider of the good or service or as a tax paid to government.[2043]

Under these approaches, the decision (where) to (re)locate would not relate to the tax burden imposed but to the favored and most efficiently organized level of government one would want to be subject to. It is uncertain whether the Tiboutian paradigm of tax competition or the idea of competing over administrative net outputs holds up (best). The correlation between taxes paid and government services rendered cannot be measured. The same goes for the fair value of government. We simply do not know.

Assessing the matter of tax rate coordination – appreciating the fiscal sovereignty of the nation state, the Tiboutian paradigm and Vogel's thoughts on administrative net outputs – I intuitively favor the upholding of tax rate disparities, perhaps within an internationally agreed broad bandwidth, or under the setting of some international minimum tax rate standard. I intuitively feel that fiscal sovereignty should remain within the realms of the nation state and the nation state's politics. The thought of a 'global taxing agency', or even a 'world government' perhaps, even if organized democratically in a constitutionally sound fashion, is a bit too far-fetched for me – too much science-fiction – at least in the world's current state.

6.5 Final remarks

[2040] Reuven S. Avi-Yonah et al, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project Discussion Paper* 2007:08, at 14.
[2041] See Charles M. Tiebout, 'A Pure Theory of Local Expenditures', 64 *The Journal of Political Economy* 416 (1956), at 416-424.
[2042] See Klaus Vogel, 'Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part II)', 10 *Intertax* 310 (1988), at 314.
[2043] See for a comparison, Reuven S. Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State', 113 *Harvard Law Review* 1573 (1990-2000), at 1592 and part III of that publication. In the current international tax regime, Avi-Yonah argues that the Tiboutian op paradigm does not uphold, where the level of government services is fixed and states finance their corporate tax incentives by increasing taxes on relatively immobile production factors (e.g. labor), In such a case, an investing multinational does not bear the additional cost of reduced governmental services by choosing the low-tax jurisdiction as the host jurisdiction provides the same level of services with the tax holiday in place by financing them through alternative means (labor and real estate taxes). Then, the tax incentive represents a pure windfall to the multinational involved as it is able to choose the optimal out of a range of available jurisdictions having similar levels of public goods provided but different corporate effective average tax rates. Avi-Yonah finds tax competition problematic to the extent that countries provide such windfall benefits to MNEs. He does not seem to have a problem with countries competing amongst each other over 'administrative net outputs', at least to the extent that levels of public goods and corporate tax burdens are congruent.

This chapter is devoted to seeking an answer to the question of how to geographically divide the corporate tax base among taxing jurisdictions. Where should we tax? How should the global firm's taxable base be allocated geographically?

The analysis has been inspired by the theory of the firm and the notion that the firm's business proceeds should be taxed once and as close as possible to its source. It has been argued that income lacks geographic attributes. Income production as the result of the interplay of firm inputs and firm outputs are as global as the multinational itself. The chapter has proceeded to assess the spectrum of possible perspectives ranging from the firms' input locations at origin to the firms' output locations at destination.

The argument made is that one should agree on the allocation key and to aim at taking away arbitrage opportunities. That would lead to an attribution of tax base by reference to elements that seem rational to use but lie outside the firm's control. In such a case, the tax allocation would operate invariantly to the location of resources. It has been argued that it would be sensible to attribute tax base by adhering to the demand side of income production. That would produce a destination-based tax base attribution approach where the tax base would be assigned to the market jurisdiction.

It has further been argued that such a destination-based tax base attribution approach would enhance fairness. It would promote a globally efficient and non-discriminatory allocation of firm inputs. The system – *Tax Payable = Tax Rate * Firm's Worldwide Rents * (Domestic Sales / Worldwide Sales*) – would cease to tax-distort investment location decisions, even in the presence of mutations in currency exchange rates and interest rates. That is, since the advocated system combines worldwide taxation with a fractional approach for the purpose of distributing the global tax pie to sovereign countries. This property, to the best of my knowledge, is an original contribution to the literature. The allocation of firm rents to the market jurisdiction would significantly mitigate the incentives to shift taxable profit by shifting corporate investment across tax borders, which exists under the current origin-oriented international tax regime.

As discussed, the ideal would be to adopt a destination-based tax base attribution approach on a worldwide coordinated basis. But also, if it would be impossible to attain international consensus, still a strong incentive would exist for individual nation states to move towards assigning the tax base to the market jurisdiction. Such a move could very likely boost domestic competitiveness, driving economic growth as a consequence. If one country were to decide to move to implementing a destination-based corporate tax system, chances are that others would follow suit. The adoption of a destination-based rents attribution by a single country may initiate a knock-on effect, producing a worldwide adoption by nation states of destination-based corporation tax systems in the equilibrium.

A transformation from the current origin-based system to a destination-based fractional system would perhaps entail a redistribution of tax revenues across countries. The distributional effects however seem impossible to predict. Matters would depend on various future behavioral effects that seem impossible to assess today. The answer to the question of which countries would gain and which would lose seems to lie in their domestic corporate sales to corporate income ratios.

With the approach advocated towards profit division, the final inadequacy in the international tax regime seems resolved. In addition to the first (Chapter 4) and second (Chapter 5) pieces of the international tax jigsaw puzzle, the final third piece seems to have also fallen into place. This paves the way for forwarding an overview of the building blocks of the advocated system in the upcoming concluding Chapter 7. That is, the 'corporate tax 2.0'.

Part V – Sharing the pie; the building blocks of a ‘corporate tax 2.0’

– Chapter 7 –

Conclusions; the building blocks of a fair international tax regime

Chapter 7 Conclusions; the building blocks of a fair international tax regime

7.1 The issue

The international corporate tax regime that is currently in place to tax firms on their business proceeds operates arbitrarily. The aggregates of the nation states international corporate tax systems seem to distort a globally efficient allocation of resources.

The current model of corporate taxation finds its origins in the 1920s. The model referred to as the 1920s Compromise in this study well-suits the economic realities of the early days of international trade and commerce, the times when international business primarily revolved around bulk trade and bricks-and-mortar industries. But those days have long since passed. Globalization, European integration, the rise of multinational enterprises, e-commerce and intangible assets have changed the world considerably.

These developments have caused the model to operate inconsistently with economic reality today. Corporate taxation and economic reality do not align anymore; the model ill-suits current market realities. This initiates tax-induced distortions in multinational business decisions. The arbitrage may work to the benefit or detriment of nationally and internationally active firms. It also seems to pressurize nation state corporate tax revenue levels. This may lead to spill-over effects and welfare losses at the end of the day. Matters seem to worsen in today's increasingly globalizing economy. This is considered unfair, i.e., inequitable and inefficient.

The distortions in the current international tax regime may be categorized into 'obstacles', 'disparities' and 'inadequacies':

- *Obstacles*; unilaterally imposed distortive tax treatment of cross-border economic activities relative to non-cross-border economic activities;
- *Disparities*; distortive tax treatment of cross-border economic activities relative to non-cross-border economic activities caused by mutual divergences between the international tax systems of states;
- *Inadequacies*; distortive allocation of tax due to the inadequate old-fashioned building blocks making up the international tax regime.

7.2 The central research question and the key sub questions

7.2.1 Central research question: how should the business proceeds of multinationals be taxed?

The question arises as to whether a proper alternative for taxing multinationals can be modeled.

How should the business proceeds of multinationals be taxed?

How should we tax multinationals in a global market? How should we share the tax pie? Is it possible to think of something better than the current model? What would such an alternative model look like? How would such a corporation tax 2.0 operate?

This study seeks to set forth a corporate taxation framework alternative to the one currently found in international taxation. It therefore departs from the starting point of not necessarily accepting the authority of currently applicable tax law. Current tax law serves illustrative rather than argumentative purposes.

7.2.2 Key sub-questions: in three steps towards fairness in corporate taxation

The study has identified three analytical steps to be taken to model an alternative framework for taxing multinational business proceeds in a global market. These steps would appear in the answers to the following three sub questions.

1. How should the notion of fairness in corporate taxation be understood?
2. How should the obstacles be resolved?
3. How should the disparities and inadequacies be resolved?

The answer to the first sub-question would provide the normative framework to assess both the properties of the current international tax regime and those of the suggested alternative approach. The answers to the second and third questions would provide the building blocks of the alternative system resolving the identified key problematic issues in the current international tax regime. These are the pieces of the international tax jigsaw puzzle.

7.3 Sharing the pie: building blocks of a fair international tax regime

7.3.1 Some thoughts on fairness in corporate taxation; a normative framework built on the equality principle

The first constituent part of the analysis (Part II, Chapter 2) addresses the first sub-question: How to understand the notion of fairness in international corporate taxation? As the authority of currently applicable law is not followed as a normative point of departure, the first step taken is to seek to develop a normative framework. What constitutes the benchmark to assess the (un)fairness of the international tax regime? What are the principles underlying a sound tax system?

For this purpose, a concept of fairness in corporate taxation is developed. It is argued that this concept is founded on the equality principle, conforming to the notion of equal treatment before the law. Economically equal circumstances should be tax-treated equally for tax purposes. Unequal economic circumstances should be tax-treated unequally to the extent of the circumstances being unequal. Cancelling out tax instrumentalism, it is argued that the equality principle and neutrality principle are interchangeable in corporate taxation. Neutral tax treatment equals equal tax treatment. And vice versa.

The argument has been made that the normative requirement of tax parity in equal economic circumstances should be kept analytically separate from the application of the respective tax laws in a particular case, as the tax effects in the respective case at hand are tested against the benchmark of the notion of tax parity in equal circumstances. Taxation is excluded as it is the subject of the analysis, much like the solution of a numerical calculation does not affect the underlying mathematical rules directing that solution.

From the equality postulate, it has been deduced that everyone in an economic relationship with a taxing state has the obligation to contribute to the financing of public goods from which one benefits in accordance with one's means – 'equity'. And the distribution of production factors should take place on the basis of market mechanisms without, or at least with as little as possible, public interference – 'economic efficiency'. Taxation should not affect business decisions, neither in a positive nor in a negative manner – tax neutrality, including the concept of neutrality of the legal form. From there on, a framework is built in which the 1920s Compromise is placed as well as the model that has been developed in this study.

It has further been set forth that:

- in a global market environment, it should be irrelevant for corporate tax purposes where the economic operator has its tax place of residence. It should also be irrelevant whether or not the economic operator involved performs its business activities in a cross-border context;

- the taxable entity for corporate tax purposes should correspond with the economic operator deriving the business income. If it concerns the taxation of a multinational firm, it would accordingly be the firm that is to be treated as the taxable entity for corporate tax purposes;
- the tax base should be designed by reference to a foundation income concept that focuses on true business income. It should resort to taxing business cash flows or economic rents, as these constitute the remuneration for the production factor of enterprise;
- the tax should be levied once at the location that corresponds with the income's geographical source as closely as possible.

Moreover, the argument has been made that fairness in corporate taxation may ultimately only be achieved through a worldwide approximation of country tax systems. Various scholars have suggested possible approaches to achieve this means. The suggestions range from global profit splits to destination-based cash flow taxes. The European Commission envisages a European Union-wide cross-border consolidated corporate tax base to be shared among the Member States by reference to a formulary mechanism; the CCCTB.

Indeed, it perhaps cannot be expected that any of these suggestions will leave the drawing board any time soon. Nation states seem politically unwilling at the end of the day to truly give up their sovereign entitlements in the field of direct taxation; and this is a necessary prerequisite to attain some form of tax approximation. Perhaps, the tax sovereignty of states needs to be respected as a given. That is, at least to some extent, for instance, regarding the establishment of the tax rate.

This does not mean that political realities provide a sufficient argument to stop thinking of an optimal international tax regime. As long as the suggestions forwarded remain to exist on the drawing board only, fairness in corporate taxation will not be achieved in reality. The status quo upholds as long as nation states remain unwilling to resolve the problems that they have created. The problems in the international tax regime will not be resolved by adhering to political realities. *"Political opposition should be recognized for what it is."*[2044]

7.3.2 Towards a fair international tax regime – eliminating obstacles: 'Worldwide taxation in the event of a domestic nexus; double tax relief in the form of a credit for domestic tax attributable to foreign income regarding a foreign nexus

The second part of the analysis (Part III, Chapter 3) addresses the second sub-question: How will the obstacles in the current international tax systems of states be resolved? The analysis builds on the prerequisite of the fiscal sovereignty in corporate taxation to lie at nation state level – i.e., as is the case in reality today.

The argument is made that a nation state's international tax system should be internally fair – a notion of 'tax fairness within the international tax system of a state'. Equal circumstances should be treated equally under the operation of the international tax system of the nation state involved. This produces a notion that has been referred to as 'internal equity' and 'internal production factor neutrality'. This concept promotes neutrality in taxation regarding both inbound and outbound movements of the production factors of capital, labor and enterprise. To the best of my knowledge, this element in the analysis is original.

The analysis demonstrates that the international adherence to the widely-known tax policy notions of capital and labor import neutrality and capital and labor export neutrality actually do not induce neutral tax treatment. Import neutrality promoting tax systems distort production factor exports. Export neutrality promoting tax systems distort production factor imports. It follows that the same holds true for the double tax relief systems common in international taxation, i.e., the base exemption method and the credit method.

[2044] Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation', *2 World Tax Journal* 3 (2010), at 15.

The point made is that ‘internal equity’ and ‘internal production factor neutrality’ call for the imposition of worldwide taxation on the business proceeds of firms that have nexus in a taxing state. This approach renders it irrelevant where the taxpayer involved has its place of residence or its place of incorporation. It operates fully in a non-discriminatory fashion accordingly.

To acknowledge the single tax principle, the unlimited tax liability should be combined with an equitable and neutral double tax relief mechanism. For that purpose, reference is made to a double tax relief mechanism referred to as the ‘credit for domestic tax attributable to foreign income’. This produces a system where all countries involved tax their fraction of the worldwide income to which they are entitled – ‘taxing the fraction’. This approach renders it irrelevant in terms of tax burdens imposed whether the taxpayer involved operates its business activities in a cross-border or purely domestic environment, also regarding the investment direction. It accordingly operates in a non-distortive fashion.

The equitable and non-distortive operation of the advocated fractional approach has been illustrated by means of numerical examples, respectively dealing with tax rate progressivity, cross-border losses, intra-firm modes of transfers and currency exchange rate mutations. To illustrate matters, the assessment undertaken engages in a thought experiment, applying identical tax systems at both sides of the tax border – i.e., to analytically cancel out the effects of the disparities in the international tax regime. The approach taken at this point analytically corresponds with the application of the ‘internal consistency test’ under US constitutional law.

It has further been argued that a consistent interpretation of the fundamental freedoms in European Union law in the field of direct taxation would necessarily need to arrive at the same system. That is as the advocated system is comprehensively non-discriminatory and non-restrictive from a European Union law perspective. Unfortunately, in its case law regarding the freedoms, the Court of Justice of the European Union adopts analytically inconsistent reasoning when interpreting the fundamental freedoms. The court arrives at analytically inconsistent approaches, thereby creating inequities, inefficiencies and legal uncertainty in the process.

The approach advocated in Part III of the analysis is unable to resolve the distortions that may arise as a result of the disparities and inadequacies in the international tax regime. These, however, do not render the analysis invalid. The approach advocated in Part III merely constitutes a first building block towards a fair international tax regime.

7.3.3 Towards a fair international tax regime; eliminating disparities adequately

7.3.3.1 Who to tax, what to tax and where to tax?

The third part of the analysis (Part IV, Chapters 4, 5 and 6) addresses the third sub-question. How will the disparities in the international tax regime be adequately resolved? This part builds on the observation that the disparities and inadequacies in the international tax regime can be taken away by means of tax coordination, i.e., approximating the tax unit definition, the tax base definition and the tax base allocation methodology. That is, to arrive at an adequately coordinated international tax regime.

Chapters 4, 5 and 6 respectively address the following three questions:

1. Who should be taxed?
2. What should be taxed?
3. Where should be taxed?

7.3.3.2 Who to tax? The group as a taxable entity

The fourth chapter seeks to answer the question of whom to tax in an alternative international corporate tax regime. What constitutes the appropriate taxable entity in a corporate tax 2.0?

The argument is made that an answer lies in cross-border tax consolidation; treat the multinational firm as a single taxable entity for corporate tax purposes. The treatment of the group as a single taxable entity for corporate tax purposes is favored over the separate entity approach that is currently in place, basically because it is principally founded on economic reality, i.e., the theory of the firm.

To define the group for corporate tax purposes, the argument is made that two criteria should be adopted. Tax consolidation should apply regarding:

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

Moreover, tax consolidation should be allowed in both domestic and cross-border scenarios. The ultimate parent could be assigned as the (principal) taxpayer for corporation tax assessment purposes.

Following the observations in Part III, the taxable entity accordingly defined – i.e., the group – should be subject to an unlimited corporate tax liability in each taxing jurisdiction in which it exceeds a minimum threshold of economic activity ('nexus'). In cross-border scenarios, double tax relief should subsequently be available by means of the credit for domestic tax that is attributable to foreign income.

The adoption of such an approach would remove all distortions that are currently caused by the commonly adopted approach to deal with each group company as a single taxable entity, resident or non-resident taxpayer for corporate tax purposes. Parity in corporate taxation would be achieved regarding both domestic and cross-border investment scenarios. It would cancel out all unilaterally imposed distortions in the corporate taxation of multinationals. Corporate tax burden and tax revenue levels would not be influenced by the multinationals' legal structuring or the question of whether business is conducted in a domestic or cross-border context. The system would accordingly be comprehensively 'obstacle-free'.

Moreover, the system would operate indifferently with regards to the legal organization of the firm. As intra-group legal realities would be disregarded, the system would not be vulnerable to paper profit shifting through intra-firm legal structuring. The system would accordingly neutralize the arbitrage in the current international tax regime involving intra-firm:

- financing arrangements;
- hybrid income and hybrid entity mismatches;
- branch (i.e., permanent establishment) versus subsidiary differentials;
- jurisdictional mismatches regarding the financing of business operations through controlled non-tax consolidated foreign subsidiary companies.

The advocated system would render superfluous the need for the ad hoc correction mechanisms that are common in today's corporation tax systems. To the extent that it concerns intra-group legal realities, there would be no need for correction measures, such as economic double tax relief mechanisms, (interest) deduction limitations, intra-firm profit pooling regimes, asset transfer regimes and intra-firm mergers and acquisitions regimes. Thin capitalization issues would be rendered moot.

The approach as advocated requires the acceptance that the problems caused by taking the separate entity assumption as a starting point in corporate taxation cannot be resolved within the tax framework that created them. The bottleneck for a proper functioning of such an approach would lie in the required political willingness of states to tax-coordinate and assist each other administratively.

7.3.3.3 What to tax? Economic rents as taxable base

The fifth chapter seeks to answer the question as to what to tax in an alternative international corporate tax regime. What constitutes the appropriate taxable base in a corporate tax 2.0?

The argument is made that an answer lies in rents taxation. That is, to appropriately resolve the financing discrimination issues that arise under a typical nominal return to equity-based tax system, i.e., the bias towards debt financing relative to equity financing under a common corporate income tax, tax should be imposed by reference to the firm's economic rents instead of the profits derived. Further, the tax coordination at this point would adequately address the hybrid income mismatches in the current international tax regime.

Rents taxation is favored over the current nominal return to equity standard, basically because it is principally founded on economic reality. Economic rents constitute the remuneration in return for the provision of the production factor of enterprise. Various commentators have resorted to advocating the approach of taxing rents instead of profits.

The approach taken is to arrive at a taxing system where, basically, only the above normal returns are taken into account for corporate tax base calculation purposes. This may be achieved technically by making use of a tax base foundation concept containing an allowance for corporate equity ('ACE'). An ACE-based foundation concept to tax business income produces c.q. promotes:

- equal to statutory average effective tax rates, as it effectively taxes business cash flows;
- nil effective marginal tax rates, accordingly leaving marginal financing decisions unaffected;
- tax neutrality in the presence of timing differentials between depreciation for tax bookkeeping purposes and economic depreciation. This is because the present values of depreciation and ACE allowances are independent of the rate against which assets are written-off in tax bookkeeping.

The effects of the system are demonstrated by means of numerical and formulaic examples. Notably, the ACE is favored over the comprehensive business income tax ('CBIT') and the cash flow taxes in their varieties.

Moreover, it has been argued that the tax cascading effects regarding equity investments in minority shareholdings may be resolved by means of a relief mechanism referred to as the 'indirect tax exemption'. This economic double tax relief mechanism would operate similarly to an indirect tax credit. That is, however, with the exception that the credit available regarding the grossed-up equity proceeds is calculated at an amount equal to the domestic tax that can be attributed to the excess earnings of the respective entity in which the equity investment is held. To efficiently arrive at a single taxation of the business cash flows involved, the economic double tax relief mechanism would be combined with a 'loss recapture mechanism' and a 'profit carry forward mechanism'. The neutral operation of such a double tax relief system is demonstrated by means of numerical and formulaic examples. To the best of my knowledge, the relief mechanism developed at this point in the analysis is original.

7.3.3.4 Where to tax? Destination-based sales-only apportionment

Locate the tax base…

Chapter 6 seeks to answer the question of where to tax in an alternative international corporate tax regime. What constitutes the appropriate tax base division key in a corporate tax 2.0?

… by reference to a destination based attribution key…

The argument is made that an answer lies in a destination-based tax base attribution approach. The tax base should be assigned geographically to the location of the firm's customers. Such an approach may appropriately resolve the arbitrage and the investment location distortions that arise in international taxation today. That is, under the current origin-based profit attribution methodology that assigns corporate tax base to the input locations by making use of the concepts of separate accounting and the arm's length standard (SA/ALS).

The observation has been made that corporate income essentially lacks geographic attributes. Income has no geographic location. The income production as the result of the interplay of firm inputs at the supply side and firm outputs at the demand side are as global as the multinational itself. This may render it somewhat pointless to search for the true source of income.

However, this does not mean that there is nothing to be said on the matter. The analysis has therefore proceeded to assess the spectrum of possible approaches ranging from the firms' input locations at origin to the firms' output locations at destination.

The argument has been made that the tax base division key should aim at taking away arbitrage opportunities. That would lead to an attribution of tax base by reference to elements that seem rational to use but lie outside the firm's control. The tax allocation would operate invariantly to the location of resources in such a case. It would be sensible to attribute tax base by adhering to the demand side of income production. That is, as firm outputs significantly lie outside the control of the firm involved – notably, the opposite holds true regarding the firm inputs at the supply side. That would produce a destination-based tax base attribution approach where the tax base is assigned to the market jurisdiction.

It has further been argued that a destination-based tax base attribution key would enhance fairness. It would promote a global efficient and non-discriminatory allocation of firm inputs. The approach taken – Tax Payable = Tax Rate * Firm's Worldwide Rents * (Domestic Sales / Worldwide Sales) – would cease to tax-distort investment location decisions, even in the presence of mutations in currency exchange rates and interest rates. That is, since the advocated system combines worldwide taxation with a fractional approach for the purpose of distributing the global tax pie to sovereign countries. This property, to the best of my knowledge, is an original contribution to the literature. The allocation of firm rents to the market jurisdiction would significantly mitigate the incentives to shift taxable profit by shifting corporate investment across tax borders, which exist under the current origin-oriented international tax regime.

… establishing nexus by reference to a quantitative turnover threshold…

As a connecting factor to establishing tax jurisdiction – identifying nexus that is – it has been advocated to replace the current permanent establishment, place of incorporation and place of effective management tests for a quantitative turnover threshold test at destination. Such a tax jurisdiction test would operate similarly to the distance sales rules in European Union value added tax and the sales factor presence tests in US state income taxation. Profit allocation by reference to separate accounting and arm's length pricing would then be abolished.

... and allocating the tax base by reference to a sales factor standard.

The advocated tax base allocation standard would assign the tax base exclusively to the customer location. It would operate conceptually equivalent to a destination-based sales factor key common in formulary apportionment systems. The place of supply rules in European value added taxation would be helpful in optimizing the design of the tax base allocation standards. Notably, a destination-based rents tax does not transform the corporate tax involved into a value added tax.

The ideal would be to adopt a destination-based tax base attribution approach on a worldwide coordinated basis. The coordination at this point would adequately put an end to the double

(non-)taxation issues that arise from income allocation mismatches under the current international tax regime.

There is an incentive for countries to implement this approach

But also, if it would be impossible to attain international consensus, still a strong incentive would exist for individual nation states to move towards assigning the tax base to the market jurisdiction. Such a move would very likely boost domestic competitiveness, driving economic growth as a consequence.

If one country were to decide to move to implementing a destination-based corporate tax system, chances are that others would follow suit. The adoption of a destination-based rents attribution by a single country may initiate a knock-on effect producing a worldwide adoption by nation states of destination-based corporation tax systems in the equilibrium. Experiences in US state income taxation provide some verification supporting this thesis by way of analogy.

A transformation from the current origin-based to a destination-based system may entail a redistribution of tax revenues across countries. The distributional effects, however, seem impossible to predict. Matters would depend on various future behavioral effects that seem impossible to assess today. The answer to the question of which countries would gain and which would lose seems to lie in their domestic corporate sales to corporate income ratios, veteris paribus. Today's major consumer markets are rarely tax havens. It may be likely that the current tax-haven countries would experience revenue reductions, while the current high-tax countries would experience revenue increases.

Maintaining fiscal sovereignty at nation state level…

The sole disparity remaining would be a tax rate disparity, i.e., to the extent that tax rates are not coordinated. By maintaining the tax rate decision at the nation state level, the countries involved would be able to maintain their sovereign entitlements in deciding on the tax burdens imposed and the chosen size of government. The consequence would be that market neutrality would not be fully realized. The differentials in effective average tax rates may, to some extent, distort the selling location. These effects may particularly arise close to international borders – 'cross-border shopping'.

… for a relatively small price

The location distortions at the demand side, however, seem less significant relative to the distortions at the supply side. Sales at destination are widely considered the least mobile tax connecting factor, i.e., relative to tax connecting factors addressing firm inputs like assets and payroll. Customer markets are immobile. The same would accordingly hold true for the mobility – or the elasticity – of the corporate tax base. Further, under a destination-based tax base attribution, key firms would still have an incentive to sell as much product as possible, even in jurisdictions putting a relatively higher weight on the sales factor. Such an incentive to sell regardless of the presence of a factor taxing it is absent at the supply side of income production.

7.3.5 Sharing the pie; building blocks of a 'corporate tax 2.0'

The building blocks of a corporate tax 2.0 have emerged; the pieces of the international tax jigsaw puzzle may seem discovered:

- Fairness in corporate taxation calls for tax parity in equal economic circumstances;
- Taxing the fraction; corporate taxpayers would be subject to worldwide taxation in each jurisdiction in which it has nexus – double tax relief would be granted by reference to the domestic tax that can be attributed to the taxpayer's nexus abroad;
- The firm involved would constitute the taxable entity;
- The firm's rents would constitute the taxable base;

- The firm's rents would be geographically assigned by reference to the firm's sales at destination.

Adopting all building blocks, the 'Corporate Tax 2.0' would boil down to the following formula:

Tax Payable by 'Firm A' in Country X
=
*Tax Rate * 'Firm A's' Worldwide Rents * (Domestic Sales / Worldwide Sales)*

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'Sharing the Pie'; Taxing Multinationals in a Global Market

The current international corporate tax regime for taxing the business proceeds of firms operates arbitrarily. The aggregates of the nation states' international corporate tax systems seem to distort a global efficient allocation of resources.

The current model of corporate taxation finds its origins in the 1920s. It well suited the economic realities of the early days of international trade and commerce; the times when international business primarily revolved around bulk trade and bricks-and-mortar industries. But those days are long gone. Globalization, European integration, the rise of multinational enterprises, e-commerce, and intangible assets have changed the world considerably.

These developments have caused the model to operate inconsistently with the economic reality of today. Corporate taxation and economic reality are no longer aligned. The model is ill-suited to current market realities. As a result multinational business decisions are distorted by tax considerations. The arbitrage may work to the benefit or detriment of nationally and internationally active firms. It also seems to put pressure on nation state corporate tax revenue levels. This may lead to spill-over effects and welfare losses at the end of the day. Matters seem to worsen in today's increasingly globalizing economy.

The question arises as to whether a proper alternative for taxing multinationals can be modeled. How should business proceeds of multinationals be taxed? Can we create something that suits the nature of a global marketplace somewhat better? What would such an alternative tax system look like? How would it operate?

This study seeks to set forth an alternative to the corporate taxation framework currently found in international taxation. The aim is to develop some building blocks for an optimal approach towards taxing the business proceeds of multinationals, i.e., a 'corporate tax 2.0'. As a starting point the authority of currently applicable national, international, and European tax law are not necessarily accepted. Accordingly, applicable tax law serves illustrative rather than argumentative purposes in this research.

The study discovers the following components for a 'Corporate Tax 2.0':

Tax Payable by 'Firm A' in Country X
=
*Tax Rate * 'Firm A's' Worldwide Rents * (Domestic Sales / Worldwide Sales)*

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