

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

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Maarten de Wilde was awarded his doctorate (cum laude) by the Erasmus University Rotterdam on 15 January 2015 for his thesis on ‘Sharing the Pie’; Taxing Multinationals in a Global Market. In his thesis, of which this contribution is a summary, De Wilde sets out a proposal for an alternative, more neutral system for taxing multinationals. His suggestion is that multinationals should be treated as a single taxable entity and granted an allowance for equity capital provided by shareholders. The proposal geographically assigns the tax base in international situations to the countries where the multinational effectively sells its products and services instead of, as is currently the case, to the countries in which its investments are located. Switching to the proposed system would seem attractive for countries and regions, both individually and as a totality, and would boost the investment climate. The manuscript of the thesis is available at ssrn.com.

1 Introduction

The taxation of multinational enterprises has attracted a great deal of attention in recent years. Countries’ corporate tax regimes appear to be influencing international business processes. As a result, business decisions taken by enterprises may sometimes be less than optimal, and this is undesirable from a perspective of business economics.

Corporate tax systems have become outdated. These systems find their origins in the 1920s and have since been patched up time and time again, such that they are now no longer fit for purpose. They were designed to suit the economic realities of those early days, when cross-border trade largely consisted of bulk goods trading and business activities requiring a physical or legal presence in a local market. Those days, however, are now long gone. Globalisation, European integration, the emergence of multinationals, digitisation and e-commerce, as well as the increased economic importance of intangibles, have all resulted in a substantially changing world. Today, multinational enterprises organise their business affairs on regional scales (EU, NAFTA, Asia-Pacific region), a global scale even. A local physical presence is not a strict necessity anymore to service domestic markets because of the internet. Corporate taxation, it seems, has completely missed the digitisation of the economy.

The way in which countries tax company profits no longer seems to align with economic reality. The taxation model applied is ill-suited to contemporary market realities, with the result that multinational business and investment location decisions are being distorted by tax considerations. Tax arbitrage can admittedly be to the benefit or detriment of individual firms at a micro-level; at a macro-level, however, it leads to spill-over effects and possibly even to reduced prosperity. And today’s increasingly global and international economy seems to be worsening matters.¹

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¹ See extensively Reuven S. Avi-Yonah, ‘Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State’, 113 *Harvard Law Review* 1573 (1990-2000).

The difficulties in the current taxation model can be divided into three categories: ‘obstacles’, ‘disparities’ and ‘inadequacies’.² By ‘obstacles’ I mean distortions to the functioning of international markets that countries create unilaterally by deciding to treat cross-border business activities differently from domestic business activities for tax purposes. Country tax systems affect decisions to take business across the border by discriminating or restricting cross border trade relative to domestic trade. This differing treatment gives rise to ‘discrimination’ and ‘restrictions’ issues, which are dealt with, for instance, in an EU context through the application of the fundamental freedoms.

By ‘disparities’ or ‘mismatches’ I mean market distortions that arise through differences between states’ international tax systems. Country tax systems are not coordinated, creating gaps and overlaps producing double tax issues and non-taxation issues. On the one hand, differences between approaches taken in country tax systems in identifying the taxable subject (who to tax) and the taxable object (what to tax), as well as mutual differences in allocating the taxable base (where to tax), result in economic double or non-taxation through, for example, hybrid entity mismatches, hybrid income mismatches and tax base allocation mismatches. On the other hand, disparate applications of the international tax principles of nationality, residence or source results in juridical double or non-taxation. Within the EU for instance, member states attempt to deal with disparities through harmonisation measures, while the OECD/G20 have addressed them in their ‘Base Erosion and Profit Shifting’ project, with its specific action points and recommendations.

By ‘inadequacies’ I mean market distortions resulting from the fact that the building blocks applied by countries seeking to subject enterprises to profit taxes have become outdated and flawed. The system basically comes apart at all seams. The separate entity approach for taxable entity definition purposes (‘separate accounting’) for instance, distorts the choice of legal form. The realisation-based nominal return to equity approach for taxable profit calculation purposes (‘nominal return to equity’) affects financing decisions. And the origin-based profit allocation methodologies used in international taxation (‘transfer pricing’) distort decisions on where to locate investments.

These various problems raise the question of whether an alternative taxation model is conceivable; in other words, a model free of obstacles and disparities, and comprising a series of ‘adequate’ building blocks. Shouldn’t we now be re-examining how we tax the profits earned by multinational businesses? Isn’t it perhaps now time to transfer the current international tax regime to a museum, along with all the other things from a bygone age? Perhaps it’s time for something new.

If that is the case, how then should we be taxing multinationals? How should we be ‘sharing the pie’?³ Is it possible to devise an alternative taxation system that is suited for taxing business profits fairly and in a manner that does not adversely affect international business and investment location decisions? How should we structure a ‘Corporate Tax 2.0’? Should we start from the principles underlying current international tax law and European law in the field of direct taxation for this purpose, or is now the right time to move away from these principles? In my view it is the latter.⁴

2 ‘Sharing the Pie’; Building blocks for a ‘Corporate Tax 2.0’

2.1 *Some thoughts on fairness in corporate taxation*

² See Chapter 1 of the thesis and Maarten F. de Wilde, ‘Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy’, 38 *Intertax* 281 (2010) (‘De Wilde 2010’).

³ 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) (‘Kaufman 1998’), at 153.

⁴ See also Arnaud De Graaf, Paul de Haan, and Maarten F. de Wilde, ‘Fundamental Change in Countries’ Corporate Tax Framework Needed to Properly Address BEPS’, 42 *Intertax* 306 (2014).

The principle on which a fair system of profit tax should be based in my view is the principle of equality, conforming to the historically widely acknowledged notion of equal treatment before the law.⁵ My basic argument is that cases that are equal economically should also be treated equally for tax purposes. By that I mean a system of taxation respecting the idea of equality in its purest and most essential form; in other words, equal treatment before the law, without the waters being muddied by any unnecessary complexity. In my view, the only function that should be seen as relevant as far as profit taxes are concerned is the budgetary function, with the sole purpose of profit taxes being to fund government spending, not to steer business decisions. That would align with the principle of neutrality and the idea that taxation should, as far as possible, have no effect on the functioning of the market. Equal tax treatment, therefore, is also neutral tax treatment, and vice versa.

From this it can be concluded that anyone with an economic link ('nexus') to a taxing country should contribute, in accordance with their means, to the funding of facilities adding to the collective well-being of the population, i.e., 'fairness'.⁶ Production factors should also be distributed on the basis of market mechanisms, without any – or at least with as little as possible – public interference, i.e., 'economic efficiency'. Taxation should not distort business processes, either positively or negatively, i.e. neutrality. The same applies with regard to decisions to structure economic activities in a particular way, i.e., 'neutrality of the legal form'.

As well as providing a structure for assessing both the current taxation model and any alternative, these starting points also create a road map for the way forward:⁷

- In a globalising market it should make no difference in terms of the profit tax burden as to where an enterprise has its place of tax residence ('non-discrimination'). So, too, should it be irrelevant whether the enterprise performs its economic activities in a domestic or a cross-border environment ('non-restriction');
- The taxable entity should accord with the economic entity performing the economic activities. If this is an economically integrated multinational, the multinational should be the taxable entity ('unitary business approach');
- The question of what is subject to tax should be based on a concept of income focusing on business cash flows. This should tie in with the 'economic rents', being the investment returns in excess of the normal returns on the production factors;
- Profit taxes should be levied once ('single tax principle'),⁸ at the geographical location most closely aligned with the geographical source of the income earned ('source').⁹

⁵ See Chapter 2 of the thesis as well as De Wilde 2010, above n. 2, and Maarten F. de Wilde, 'A Step towards a Fair Corporate Taxation of Groups in the Emerging Global Market', 39 *Intertax* 62 (2011) ('De Wilde 2011-I').

⁶ See, e.g., 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, Kaufman 1998, above n. 3, at 145-203 and Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapter 1.

⁷ See Chapter 2 of the thesis and De Wilde 2011-I, above n. 5.

⁸ See 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.

⁹ 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.

A profit tax meeting all these conditions would seem possible only if countries were to move to worldwide harmonisation of their profit tax systems.¹⁰ Literature contains a range of proposals in this respect, varying from ‘global profit splits’¹¹ to ‘destination-based cash flow taxes’.¹² The European Commission proposal for a Common Consolidated Corporate Tax Base seeks an EU-wide harmonised approach for taxing profits of European business enterprises by dividing corporate tax base among the member states by reference to a formulary mechanism.¹³ The OECD/G20 meanwhile have addressed the issue through the series of specific action points published as part of the ‘Base Erosion and Profit Shifting’ project.¹⁴

Time will tell as to what extent these proposals prove successful and actually result in improvements. Any such coordination will require the nation states in question to renounce part of their fiscal autonomy. Although they do not yet seem very willing to go down that route at this stage, this situation could potentially change. On the one hand, the view that the principle of countries’ fiscal sovereignty in the field of direct taxes has to be respected is broadly accepted. On the other hand, however, recent initiatives by the OECD/G20, for example, specifically point in the direction of steps towards greater coordination.

The feasibility of any proposed change is entirely reliant on whether the political world is genuinely willing to change the current model of taxation. It is nevertheless important, in my view, for academics to consider the options for optimising profit tax regimes. The international tax regime as it currently stands by no means is a status quo, nor should be seen as such.

2.2 *Towards an international profit tax regime free of obstacles; unlimited tax liability on domestic ‘nexus’ and ‘Dutch-style’ double tax relief for foreign ‘nexus’*

In the introduction, the difficulties in the current tax system are categorised as ‘obstacles’, ‘disparities’ and ‘inadequacies’. If the fiscal sovereignty of states has to be regarded as a given and the focus consequently shifts to what countries can do unilaterally, the question arises as to how states can achieve an ‘obstacle-free’ tax system.¹⁵ How should they eliminate the current obstacles? As these market distortions have been unilaterally imposed, the countries imposing them can also eliminate them without having to engage in tax coordination. Problems involving transfers of sovereignty and the related political sensitivities will not then be an issue.

¹⁰ See Michael P. Devereux, ‘Taxation of outbound direct investment: economic principles and tax policy considerations’, 24 *Oxford Review of Economic Policy* 698 (2008) (‘Devereux 2008’), at 700, 707 and 716.

¹¹ See Jinyan Li, ‘Global Profit Split: An Evolutionary Approach to International Income Allocation’, 50 *Canadian Tax Journal* 823 (2002).

¹² See Alan J. Auerbach, Michael P. Devereux and Helen Simpson, ‘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) (‘Auerbach et al 2008’).

¹³ Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 2011/0058 (CNS).

¹⁴ 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.

¹⁵ See Chapter 3 of the thesis, and De Wilde 2010, above n. 2, De Wilde 2011-I, above n. 5, as well as 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 (‘De Wilde 2011-II’).

As I see it, the tax system of a state should be ‘internally fair’, such that economically equal circumstances are treated equally under the operation of the specific state’s international tax system. This notion can be referred to as ‘internal equity’ or ‘internal production factor neutrality’. Such a concept would promote neutrality in taxation regarding both inbound and outbound movements of the production factors of capital, labour and enterprise. Not only the production factor of import or export neutrality, as in the case of the capital import neutrality and export neutrality concepts. Tax systems promoting import neutrality distort outbound investments by, for example, disallowing loss imports,¹⁶ while tax systems promoting export neutrality distort inbound investments by, for instance, levying additional tax up to the residence state level and thus creating a competitive disadvantage for the taxpayer in the source state.¹⁷ It has been noted in literature that neither neutrality concept is in fact neutral.¹⁸ The same necessarily applies to the usual international methods of granting relief on double taxation, namely base exemptions and credits.

An internally fair system would mean an unlimited tax liability for all operators with an economic presence (‘nexus’) in the relevant taxing jurisdiction. As each taxpaying enterprise would accordingly be taxed on its worldwide business income, its place of residence would become irrelevant for corporate tax purposes. Non-discrimination issues would accordingly not arise. In order to ensure single taxation in cross-border situations, this principle of unlimited tax liability would have to be combined with a neutral mechanism of double tax relief. This could be done through a system of tax relief located, conceptually, somewhere between a base exemption and a credit mechanism, and which would simultaneously also promote both inbound and outbound neutrality. I found such a neutral double tax relief mechanism in the current Netherlands’ international individual income tax system: the Netherlands-style ‘tax exemption with progression mechanism’. Please note that unlike the reference to the term ‘exemption’, the Netherlands-style tax exemption mechanism actually is not a base exemption mechanism at all. Effectively, it operates as a credit mechanism, whereby the relief granted equals the amount of domestic tax that is attributable to the taxpayer’s foreign income. Instead of crediting the amount of foreign tax paid – as is typical under a common credit mechanism – the Dutch-style relief method provides relief for an amount equivalent to the relief amount as calculated under the second limitation in the ordinary credit method. The double tax relief is accordingly calculated without looking at the actual foreign tax paid, i.e., as the ‘Corporate Tax 2.0’ seeks for internal consistency.¹⁹ This double tax relief mechanism used to be applied in the Netherlands in the area of international corporate income taxation as well. Unfortunately, the Netherlands abolished it in the area of corporate taxation as per 2012 to replace it for a distortive base exemption mechanism.²⁰

¹⁶ 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.

¹⁷ See Klaus Vogel, ‘Which Method Should the European Community Adopt for the Avoidance of Double Taxation?’, 56 *Bulletin for International Taxation* 4 (2002), at 4-10.

¹⁸ See Michael P. Devereux and Peter Birch Sørensen, ‘The Corporate Income Tax: International Trends and Options for Fundamental Reform’, *European Commission, Directorate-General for Economic and Financial Affairs*, Economic Paper No. 264 (2006).

¹⁹ For analytical purposes use has been made of the notion of ‘internal consistency’ in US constitutional law. For extensive analyses of the ‘internal consistency test’ see Ruth Mason, ‘Made in America for European Tax: The Internal Consistency Test’, 49 *Boston College Law Review* 1277 (2008), at 1283, as well as Walter Hellerstein, ‘Is “Internal Consistency” Dead?: Reflections on an Evolving Commerce Clause Restraint on State Taxation’, 61 *Tax Law Review* 1 (2007-2008) and Walter Hellerstein, ‘Is “Internal Consistency” Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation’, 87 *Michigan Law Review* 139 (1988-1989).

²⁰ For critique see 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).

Combining an unlimited tax liability for all taxpayers, irrespective of their residence, with tax relief for all foreign income would create a tax system where all countries involved would effectively tax their fraction of the worldwide income to which they are entitled, i.e., ‘taxing the fraction’, or ‘fractional taxing’.²¹ Such an approach results in the same effective tax burden imposed in both domestic and cross-border situations. No longer, therefore, would the tax burden be relevant for the direction of investments. Such a system would be internally consistent and result in a non-discriminatory and non-restrictive taxation that would be fully compatible with the EU freedoms because of its ‘obstacle free’ properties. This, therefore, constitutes the first building block for a ‘Corporate Tax 2.0’.²²

2.3 *Towards an international profit tax regime without ‘disparities’ and ‘inadequacies’*

2.3.1 *Who to tax, what to tax and where to tax?*

If the obstacles can be eliminated, the focus can return to coordination as a means of adequately resolving disparities. If states can be assumed to be willing to resolve disparities by allowing their tax systems to converge, the next question arising is what such a converged tax model would look like? How should the taxable entity be defined (‘who to tax’)? How should the tax base be established (‘what to tax’)? And how should the tax base be apportioned internationally (‘where to tax’)?

2.3.2 *Who to tax? The group as a taxable entity*

Who is the appropriate taxable entity in the ‘Corporate Tax 2.0’?²³ The unitary business approach implies mandatory cross-border tax consolidation, whereby the multinational firm is treated as a single taxable entity for corporate tax purposes. This approach should, in my view, be favoured over that of the separate entity approach, essentially because the former is founded on economic reality, as explained the theory of the firm – and because the latter proves distortive.²⁴ This, therefore, constitutes the second building block.

Two criteria can be adopted to define the group for corporate tax purposes. Tax consolidation should apply when the ultimate parent company:

- has corporate interests that give it a decisive influence over the structure and management of the underlying business activities of the subsidiaries, provided that;
- the parent company holds these corporate interests as a capital asset.

²¹ See 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, and Kees 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.

²² For some numerical examples illustrating the effects of such an approach, see Chapter 3 of the thesis and De Wilde 2011-II, above n. 15.

²³ See Chapter 4 of the thesis and De Wilde 2011-I, above n. 5.

²⁴ The ‘theory of the firm’ has originally been stated by Coase, see Ronald H. Coase, ‘The Nature of the Firm’, 4 *Economica* 386 (1937).

Moreover, tax consolidation should be allowed in both domestic and cross-border scenarios ('worldwide tax consolidation').²⁵ The ultimate parent could be designated the principal taxpayer for corporate tax assessment purposes and would receive the tax assessment.

This will result in an unlimited corporate tax liability for all groups with a nexus with the relevant taxing jurisdiction, while tax relief would be available in cross-border scenarios under the Dutch-style relief mechanism in order to efficiently avoid double taxation of the group's foreign income.

Such an approach would at once eliminate all the distortions caused by the current taxation model, whereby each group company – resident or non-resident – is in principle treated as a single taxable entity for corporate tax purposes. Complete parity in corporate taxation would be achieved, both in domestic and cross-border investment scenarios. A multinational's corporate tax burden would then no longer be influenced by its legal structuring or whether its business activities have been conducted in a domestic or cross-border environment. This would also apply to countries' tax revenues; in other words, the obstacles impeding the taxation of multinationals would be comprehensively eliminated.

This system would moreover create neutrality with regard to legal form, for the manner in which firms arrange their business affairs legally no longer being of relevance for tax purposes. Eliminating intra-firm transactions and intra-firm legal relationships for corporate tax purposes would, for example, neutralise the arbitrariness in the current international tax regime that arises in consequence of the differing treatments of permanent establishments and subsidiaries. Withholding taxes on outbound intra-firm payments could be abolished.

The need for many of the correction mechanisms commonly applied in today's corporate tax systems would disappear, while economic double tax relief mechanisms such as withholding tax exemptions, participation exemptions and indirect tax credits within a group of affiliated entities would become superfluous, as would interest and other deduction limitations, profit pooling regimes, asset transfer regimes and intra-firm mergers and acquisitions regimes. Thin capitalisation issues, too, would be rendered moot – so would in fact all issues in corporate taxation relating to intra-group financing arrangements.

Acceptance of the approach as advocated in this paper requires acknowledgement that the problems in the current taxation model cannot be resolved within the tax framework that created them. It is noted that whether such an approach is able to succeed will greatly depend on the political willingness of states to assist each other administratively.

2.3.3 *What to tax? Economic rents as taxable base*

What constitutes an appropriate taxable base in the 'Corporate Tax 2.0'?²⁶ The above reference to economic rents implies an approach based on the concept of excess earnings;²⁷ in other words, taxation only of returns generated above or in excess of normal investment returns by means, for

²⁵ The approach taken resembles the concept of 'worldwide unitary combination' known in US state taxation. See for extensive analyses of the concept and its properties and implications Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination*, Stanford: Hoover Institution Press, 1984 ('McLure 1984').

²⁶ See Chapter 5 of the thesis.

²⁷ 'R-I'; see Willem Vermeend, Rick van der Ploeg and Jan Willem Timmer. *Taxes and the Economy: A Survey of the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment*. Edward Elgar Pub, 2008, at 41-45.

example, of a deduction for equity financing. I would favour such an approach over the current nominal return to equity standard. Economic rents constitute the remuneration granted in return for the provision of the production factor of enterprise, and thus a basis for tax base computation grounded in economic reality. Furthermore, this concept of taxable profit would not affect financing decisions, whereas the deductibility of interest in the current system encourages debt financing rather than equity financing.²⁸ The deduction for equity financing thus constitutes the third building block in the ‘Corporate Tax 2.0’.

Various commentators have previously advocated taxing rents instead of profits.²⁹ Such a system can be achieved technically by allowing a deduction for equity financing in the form of an allowance for corporate equity.³⁰ Losses could be carried forward on an interest-bearing basis. An allowance for corporate equity would result in:

- A reduction in the financing discrimination and, therefore, the extent to which tax considerations influence financing decisions. Granting an allowance for equity capital would reduce the bias towards debt financing in the current system. Although a distinction would still have to be made between the two forms of financing, the availability of a deduction for both would take the tension out of the system. This would moreover affect only third-party financing as the significance of intra-firm financing would have been eliminated through tax consolidation;
- Effective average tax rates equal to the statutory rates as only business profits in excess of normal return equity returns would be taxed;
- Nil effective marginal tax rates, with the result that marginal financing decisions would be left unaffected;
- A reduction in the importance of timing differentials between depreciation for tax purposes and economic depreciation.³¹ Hidden reserves, for example, would result in a lower allowance for corporate equity. Economic gains attributable to the deferral of taxable profit realisations would be offset by a countermeasure, while the same would also apply to economic losses if realisation of tax losses is deferred for tax purposes. This would remove the tension from, and therefore also the economic importance of, decisions on when to recognise losses for tax purposes. The same applies to accelerated depreciation systems and roll-over relief mechanisms. The economic value of deferred tax assets and deferred tax liabilities in present value terms would accordingly turn out to be nil.

Economic double taxation of proceeds derived from equity investments in minority shareholdings could be resolved efficiently by introducing an economic double tax relief mechanism that may be referred to as the ‘indirect tax exemption’.³² Such a mechanism would operate conceptually similar

²⁸ See Serena Fatica Thomas Hemmelgarn, and Gaëtan Nicodème, ‘Taxation Papers; The Debt-Equity Tax Bias: Consequences and Solutions’, *European Commission Directorate-General Taxation & Customs Union Working Paper* 2012:33.

²⁹ 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 Auerbach et al 2008, above n. 12.

³⁰ See the proposal for an ‘allowance for corporate equity’ 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 and Harold Freeman, ‘A general neutral profits tax’, 12 *Fiscal Studies* 1 (1991), at 12-15. The allowance for corporate equity has been based on an earlier proposal for a ‘capital cost deduction’ forwarded by Robin Broadway and Neil Bruce, ‘A general proposition on the design of a neutral business tax’, 24 *Journal of Public Economics* 231 (1984), at 231-239.

³¹ See, e.g., Ruud A. de Mooij and Michael P. Devereux, ‘An applied analysis of ACE and CBIT reforms in the EU’, 18 *International Tax and Public Finance* 93 (2011).

³² See Chapter 5 of the thesis, also for some formulaic and numerical examples illustrating the effects of the approach taken.

to the Dutch-style double tax relief mechanism addressed in the above. It would basically operate as an indirect tax 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. This would involve an indirect tax credit for the grossed-up equity proceeds (dividends, capital gains), with the level of this credit being determined by the domestic tax provisions in the relevant taxing state. This mechanism would accordingly be comparable to any indirect credit mechanism for underlying tax, but then with a tax credit at the effective domestic tax rate rather than the foreign rate. In order to efficiently ensure single taxation of the cash flows involved, the relief mechanism would be combined with loss recapture and profit carry-forward mechanisms.

2.3.4 Where to tax? Assigning the tax base to the market jurisdiction

Assign the tax base ...

How would the tax base be apportioned between countries in a ‘Corporate Tax 2.0’?³³ It was argued above that profits should be taxed once at the location closest to the geographical source of the income generated. This implies an approach focused on identifying the source of income produced. But where is income located? And so where, therefore, is the fourth building block?

Ultimately there is not much more to say about geographically assigning a tax base than to state that the choice made should be reasonable.³⁴ As I see it, there is no such thing as a ‘correct’ allocation of profit, given that corporate profits have no geographic attributes.³⁵ Income, therefore, has no ‘true’ geographic location. Income is an amount, the result of the interplay of business inputs on the supply side (‘state of origin’, ‘production jurisdiction’ and ‘cost side’) and business outputs on the demand side (‘destination state’, ‘market jurisdiction’ and ‘revenue side’).³⁶ It has no location. Corporate profits are equally multinational as the multinational firm generating them. This holds true regardless of the application of *any* procedure to geographically divide multinational profits for tax base allocation purposes.³⁷

Once a choice has to be made, the apportionment mechanism should be as neutral as possible in order to minimise opportunities for arbitrage. This suggests aligning with elements that are economically rational, but that lie, as far as possible, outside the relevant firm’s control.³⁸ That would minimise the apportionment mechanism’s impact on the allocation and apportioning of

³³ See Chapter 6 of the thesis.

³⁴ See, e.g., 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: “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”.

³⁵ 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 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.

³⁶ 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*. New York: Oxford University Press, 2000 (‘Cnossen 2000’), at 46-77, Peggy B. Musgrave, ‘Principles for Dividing the State Corporate Tax Base’, in McLure 1984, above n. 25, at 228-246.

³⁷ Cf. Richard M. Bird and J. Scott Wilkie, ‘Source vs. residence-based taxation in the European Union: the wrong question?’, in Cnossen 2000, above n. 36, at 91.

³⁸ Cf. Charles E. McLure, Jr, ‘Comments on Musgrave’, in McLure 1984, above n. 25, at 251.

production resources. In a global market, only a neutral apportionment mechanism can produce an immobile and inelastic corporate tax base.

... to the market jurisdiction ...

An apportionment mechanism that is more neutral than the mechanism currently used can be achieved by aligning with the demand side and, therefore, by allocating the tax base to the market jurisdiction.³⁹ The tax base will then be located in the countries where the multinational's products and services are effectively sold. The demand side is relevant for generating profits, but is outside the relevant multinational's sphere of influence, or at least in any event further away than the supply side, which the current taxation model uses as the basis for allocating profits and which is entirely within the firm's sphere of influence. Aligning with the supply side may encourage multinationals to invest in countries with the lowest tax rates.

Assigning the tax base to the market jurisdiction would eliminate the distortions in investment location decisions and the opportunities for arbitrage that the current taxation model creates. The current model is based on the principle of each economic entity being independently liable for tax ('separate accounting') and on internal transfer prices set by reference to comparable third-party transactions ('arm's length pricing'). Ultimately the current model seeks to attribute the tax base to the countries in which the firm invests – in other words, the input locations on the supply side – while at the same time failing to identify sources of business profit in the destination jurisdiction by taking no account of the demand side.

Attributing the tax base to the market jurisdiction would promote a globally efficient and non-discriminatory allocation of production inputs.⁴⁰ Basing taxation on this mechanism would end the distortion of investment location decisions and so promote the optimisation of prosperity. The fractional approach and allowance for corporate equity mean that this would also apply in the event of exchange rate movements.⁴¹ It would also eliminate the incentives, both for multinationals and sovereigns, to shift taxable profits. Assigning the tax base to the market jurisdiction consequently constitutes the fourth building block.

... by establishing nexus by reference to a quantitative turnover threshold...

As connecting factors for establishing tax jurisdiction, concepts such as 'permanent establishment', 'place of incorporation' and 'place of effective management' would have to be replaced by a factor reflecting the assigning of the tax base to the market jurisdiction. A possible factor could be a quantitative turnover threshold that would operate similarly to the rules on distance sales in EU value added tax, or the sales factor presence tests that some US states apply in the area of state income taxation.⁴²

... and geographically allocating the tax base by reference to a sales factor standard.

³⁹ See Auerbach et al 2008, above n. 12, and Kimberly A. Clausing and Reuven S. Avi-Yonah. 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project*, Discussion Paper 2007-08 (2007) ('Clausing et al 2007').

⁴⁰ See, e.g., Ana Agúndez-García, '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.

⁴¹ See Chapter 6 of the thesis for some numerical examples illustrating the effects adhering to interest rate parity theory.

⁴² See Clausing et al 2007, above n. 39.

Allocating the tax base to the market jurisdiction means attributing the goods or services to the customer's location. This could be done using a sales factor standard comparable to the destination-based sales factor keys used in US states' income taxation systems. The 'place of supply' rules in European value added taxation could be helpful in optimising the design of such a standard. It should be noted that assigning the tax base to the market jurisdiction will not transform the corporate tax into a value added tax and that it will remain a tax on rents.⁴³

Ideally a destination-based tax base, such as outlined above, would be adopted on a worldwide, coordinated scale as this would boost the global investment climate and put an end to double and non-taxation issues arising through allocation mismatches.⁴⁴ The reality of the current political climate means, however, that such a move is less than likely, and is certainly not probable at any time in the near future.

Incentive for countries to implement this approach ...

Even, however, if it proves impossible to attain international consensus, a strong incentive still exists for individual nation states or regions (the EU or NAFTA, for example) to move towards the tax model advocated. It would boost domestic competitiveness in the country or region, as well as boosting investment and driving economic growth.

If a country or region were to decide to implement taxation of above-normal profits in a system assigning the tax base to the market jurisdiction, this would make that country or region relatively more attractive for, and thus boost, domestic investments. If the first mover in this respect is economically and geopolitically relevant, other countries will have little option but to follow.⁴⁵ This in turn may have a knock-on effect, with the result that the interaction between the different states' tax systems will become increasingly neutral, as more and more countries would adopt the new approach.⁴⁶

Is this realistic? Maybe it is, maybe it isn't. Whatever the case, developments in the United States with regard to sales-only apportionment within the states' corporate tax systems show that a process of spontaneous coordination need not be inconceivable. Once one state, Iowa, introduced such a destination based tax base allocation system, others started following suit for reasons of self-interest, and this process continues to this day.⁴⁷ A comparable movement could be reproduced at a global level.

A transformation from the current origin-based to an alternative, destination-based system could result in a redistribution of tax revenues across countries. Any such redistributive effects are, however, difficult, if not impossible, to predict and would depend on various future behavioural effects that are far from easy to predict at this stage. All other things being equal, the answer to the

⁴³ See for a comparison Peter Mieszkowski and John Morgan, 'The National Effects of Differential State Corporate Income Taxes on Multistate Corporations', in McLure 1984, above n. 25, at 257: "*a tax on capital is a tax on capital*."

⁴⁴ See Clausing et al 2007, above n. 39.

⁴⁵ See for a comparison Kelly D. Edmiston, 'Strategic Apportionment of the State Corporate Income Tax', 55 *National Tax Journal* 239 (2002), at 239-262, and Clausing et al 2007, above n. 39, at 13.

⁴⁶ See Kimberly A. Clausing and Reuven S. Avi-Yonah, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment', *The Hamilton Project*, Discussion Paper 2007-08 (2007).

⁴⁷ See, e.g., Stefan Mayer, *Formulary Apportionment for the Internal Market*, International Bureau of Fiscal Documentation, 2009, at 95 and David Spencer, 'Unitary taxation with combined reporting: The TP solution?', *International Tax Review*, 25 April 2013, at 2-5.

question of which countries would gain and which would lose would seem, therefore, to lie in the countries' 'domestic corporate sales to corporate income' ratios.⁴⁸

... maintaining fiscal sovereignty ...

Whatever happens, tax rate disparity will continue under the advocated model. By maintaining the right to set tax rates at a national level, the countries involved will retain their sovereignty in tax policy matters and their chosen size of government. Market neutrality will consequently not be fully realised.⁴⁹ Rate disparities will distort selling locations, with 'cross-border shopping' effects – such as when Dutch motorists cross to Luxembourg to fill up their fuel tanks – likely to be more evident close to international borders.⁵⁰

... for a relatively small price.

Location distortions on the demand side would seem, however, less significant than those on the supply side. Sales at destination are widely considered to be the least mobile connecting factor for tax purposes, relative to factors based on firm inputs such as labour and assets. Customer markets are not highly mobile. The same accordingly holds true for the mobility – or elasticity – of the corporate tax base. Furthermore, businesses would still have an incentive under a destination-based tax base to sell as much product as possible, even in jurisdictions with relatively high tax rates.⁵¹ Such an incentive to sell, regardless of tax, is absent on the supply side of income production. Imposing tax on the cost side acts as an incentive to produce in relatively lower-taxed jurisdictions, irrespective of the applicable tax rate. And this is what is feeding the 'race to the bottom' in the current taxation model.⁵²

3 Conclusion

The building blocks for an alternative corporate tax system have emerged.⁵³ For a fair system of tax, tax parity should apply in equal economic circumstances. The four building blocks for such a system are consequently:

- 'Taxing the fraction'; an unlimited tax liability in each jurisdiction in which a taxpayer has nexus, with relief in the event of a foreign nexus – double tax relief would be granted by reference to the domestic tax that can be attributed to the taxpayer's nexus abroad;
- The multinational constitutes the taxable entity;
- The firm's rents constitute the taxable base;
- The tax base would be geographically assigned to the market jurisdiction.

If all the above building blocks are adopted, the 'Corporate Tax 2.0' boils down to the following formula:

<i>Tax Payable by Firm A in Country X</i>

⁴⁸ See Clausing et al 2007, above n. 39, at 25.

⁴⁹ The term 'market neutrality' has been derived from Devereux 2008, above n. 10, at 700, 707 and 716.

⁵⁰ See for a comparison, 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.

⁵¹ See Clausing et al 2007, above n. 39, at 12.

⁵² See for some analysis and assessment Maarten F. de Wilde, 'Tax competition within the European Union – Is the CCCTB-directive a solution?', 7 *Erasmus Law Review* 24 (2014).

⁵³ See Chapter 7 of the thesis.

$$=$$
$$\text{Tax Rate} * \text{Firm A's Worldwide Rents} * (\text{Domestic Sales} / \text{Worldwide Sales})$$

The above seems relatively easy to follow. The question, of course, is whether this model will work out so easily in practice. Whatever the case, I hope in any event that it will contribute to discussions of an issue that seems likely to occupy minds for some time to come; in other words, the issue of 'How to tax multinational profits?'