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INTEGRATION APPROACHES
TO GROUP TAXATION
IN THE EUROPEAN INTERNAL MARKET

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for the Degree of Doctor of Philosophy

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I hereby declare that the work presented in this thesis is my own.

Signature

Date 24th Sept. 2007
ABSTRACT

The creation of a group taxation framework to subject affiliated entities resident in more than one EC Member State to a single set of rules is an experiment without precedent. Group taxation normally deals with tax liability in the context of a single jurisdiction. There is no system of group taxation worldwide which embraces more than one fiscal jurisdiction under a single regulatory umbrella. This thesis explores the prospect for creating a group taxation system extending across national borders in the EC. The objective is to specify what shape the elements of such a system should take as well as to identify the areas of complexity or probable impasse.

The first two chapters set the background: the jurisprudential and legislative framework of the EIM within which any potential group taxation project should develop.

The third chapter surveys the tax systems of Canada, Switzerland and the US with a focus on the principles pertaining to the division of power between the federal and sub-federal tiers.

Chapter 4 presents and debates the policies for corporate taxation in integrated markets. An attempt is made to answer whether regulation should be treated as a prerequisite for corporate tax coordination. The objectives of the EIM and possible instruments leading to their attainment are placed within the framework of a group taxation scheme.

Chapter 5 classifies the issues relevant to the administration of the scheme into four categories: compliance, enforcement, dispute resolution and re-assessment of tax liability. As the unique constitutional structure of the EIM cannot easily be linked to a precedent, the discussion is more about setting the principles of a new construction rather than proposing adjustments to existing schemes.

Chapter 6 aims at setting forth a test for entitlement to group membership. It discusses established tests and advances arguments for an ownership criterion based on a holding percentage.

Chapter 7 focuses on tax base integration. The approach taken is in favour of a broad definition which does not introduce a distinction between business and non-business income.

The territorial delineation of the group is explored in chapter 8. The discussion starts from the assumption that ‘water’s edge’ is applicable. This chapter examines the interaction between formulary apportionment (FA) and the international tax law principles of source/residence.

Chapter 9 explores FA. The specific formulation of the mechanism for apportionment is primarily an economists’ responsibility. This thesis limits itself to comments of a legal nature, such as the amount of diversity that should be allowed, without causing distortion, in the formulae applicable across the EC.

Finally, conclusions are drawn about the research questions posed.
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For my parents.

I dedicate this work to the memory of my grandfather.
INTRODUCTION

Group taxation is a fundamental element found in many corporation tax systems. This is a mechanism for computing liability to tax which, depending on the shape it takes, grants certain fiscal advantages to affiliated entities. The creation of a group taxation framework to subject affiliated entities resident in more than one Member State under a single set of rules is an experiment without precedent. This may either be shaped as a single set of uniform rules for the European Internal Market (EIM) or common provisions applicable across each cross-border group.

The Objective

This thesis explores the prospect for creating a group taxation system of this form. The objective is to specify what shape its elements should take as well as to identify the areas of complexity or impasse.

The novelty of such a group taxation scheme originates in a combination of features.

One aspect is the multi-jurisdictional nature of the group, as it is meant to incorporate entities from different Member States. Group taxation normally deals with tax liability in the context of a single jurisdiction. In practice, there is no system

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1 Citations in this thesis follow 'The Oxford Standard for Citation of Legal Authorities' (OSCOLA 2006). This is available at <http://denning.law.ox.ac.uk/published/oscola_2006.pdf>.

2 A similar scheme also exists in the field of VAT under the term 'VAT Grouping': see Chapter 6, Part A, Section IV.
of group taxation worldwide which embraces more than one fiscal jurisdiction under a single regulatory umbrella. It will be shown in this thesis that schemes operated by a few EC Member States (i.e. Austria, Denmark, (partly) France and Italy), which allow foreign residents into their domestic groups, are not genuinely cross-border structures.\(^3\) US unitary taxation is closer to involving more than one jurisdiction at sub-federal level.\(^4\) Still though, there is no facility to have the tax liability of each group computed once among the States eligible for part of the tax base. Rather, each State carries out its own calculations.

Secondly, the scheme will operate in the EIM, being a structure without international precedent, which functions through a fine balance between state sovereignty and market integration objectives. Those two concepts often clash, as they usually reflect conflicting interests. On the one hand, the Member States enjoy sovereignty in the areas where competence has not been conferred on the EC.\(^5\) Considering that the power to levy taxes in principle falls within the exclusive competence of the Member States,\(^6\) the latter retain their full sovereignty in fiscal matters. On the other hand, integration (through the abolition of obstacles) is a fundamental objective of the EIM.\(^7\) It will be explained in this thesis\(^8\) that market integration in the EC presupposes a certain degree of uniformity to be achieved through enacting common rules. That would force the Member States to concede aspects of their sovereignty, which would raise resistance, especially in a non-harmonised area such as direct taxation.

The idea of devising a group taxation system applicable within the unique constitutional framework of the EIM is not an originality of this thesis. Rather, this

\(^3\) Chapter 7, Part A, Section II.
\(^4\) Chapter 6, Part A, Section III and Chapter 8, Part A, Section I.
\(^5\) The competence of the EC may be exclusive or, subject to the principle of subsidiarity, shared with the Member States (EC Treaty (hereinafter TEC) (Treaty of Rome, as amended) art 5). It follows that the more extensive the concession of competence to the EC in a certain field, the less sovereign the Member States in that regard.
\(^7\) TEC arts 3(1)(c) & 14(2).
\(^8\) Chapter 4, Part B, Section I.
is a policy choice which is broadly set out in the European Commission Staff Working Paper⁹ on company taxation. The contribution of this thesis is to reach certain conclusions on what should be the content of each of the group's elements. In some cases, the feasibility of implementing specific aspects will also be debated.

This work does not treat the systems proposed in the Staff Paper as a starting point of the analysis. Obviously, account is taken of the CCCTB¹⁰ and HST,¹¹ having been the two schemes promoted in the aftermath of the Staff Paper's reception by experts and the industry.¹² However, this is done in the context of a discussion which starts exploring the issues from the very first principles. Those basically touch upon the nature of the EIM and its objectives for market integration¹³ as well as the jurisprudential precedent of the European Court of Justice (ECJ).¹⁴

The proposal for subjecting multinational enterprises (MNEs) to a single set of rules in the EC is aimed at tackling a series of disadvantages that create obstacles for businesses. Those have been identified in the Staff Paper but cannot be struck down by the ECJ, as they do not breach directly effective provisions of the EC Treaty.

It will be shown in Chapter 1 that, to qualify for a breach of EC Law, the facts of a case should be either 'discriminatory' or 'restrictive' (as per the construction of the ECJ).¹⁵ Those tests are of a bilateral nature. They may take the form of a comparison between a domestic and a cross-border intra-EC situation leading to disadvantageous treatment of the latter. In addition, it often suffices that there is a finding of impediment to free movement with an intra-EC dimension.

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¹⁰ Common Consolidated Corporate Tax Base: see Staff Paper 375 et seq.
¹³ Staff Paper 25 et seq.; Chapter 4, Part B, Section II, Title 1.
¹⁴ Chapter 1.
¹⁵ Chapter 1, Part A, Section II.
It will be discussed in Chapter 4 of this thesis that the provisions of the EC Treaty on the fundamental freedoms do not themselves place a requirement for uniform regulation. Thus, those are given a bilateral structure. The disadvantageous aspects of the EC identified in the Staff Paper go far beyond these bilateral tests and what can be held illegitimate by the ECJ. For instance, the costs of complying with transfer pricing formalities do not in principle qualify as an infringement of the freedoms. Still though, this is a serious obstacle deterring commercial activity in the EIM.

The Research Questions

The general research question of this thesis has already been stated: what shape should be given to the elements of a group taxation system extending beyond the contours of a single jurisdiction across the entire EC. This can be broken down into a number of more specific questions which constitute separate items of research in this thesis.

One crucial matter is how the group should be defined. There are two aspects in this.

The first aspect involves how it should be determined which entities are eligible for group membership. This primarily concerns the required degree of affiliation. Different approaches to affiliation tests can be identified worldwide. One key question is whether the choice should be for an ownership- or control-based test or, alternatively, more substantive requirements pointing to business unity should be laid down. The decision is significant because it may have an impact on the function of the mechanism for allocating the group tax base to the eligible Member States. More precisely, it all boils down to whether an ownership or control test is compatible with allocation by apportionment.
A second aspect to group definition deals with the territorial scope. Should the group extend beyond the EC? If not, what about third-country located PEs of EC resident group affiliates? Conversely, should EC-located PEs of third-country affiliates be incorporated into the group? A critical element in providing answers to all these questions is linked to the following ‘uneasy’ interaction: Formulary Apportionment (FA), applying intra-group, is not in principle compatible with the system of DTCs which is in place between Member States and third countries.

Another element setting forth issues for research concerns the methods of integration of the individual tax bases into a single group tax base. Clarifying concepts such as consolidation and pooling is part of the process leading to the policy choice. One question here involves the degree of uniformity required for accomplishing the objectives initially set. Finally, a key matter is to determine which revenues should be admitted as part of the tax base.

This thesis attempts to explain how FA is beneficial to the EIM. In doing this, comparisons are drawn with the method of pricing at arm’s length. The required degree of uniformity of the rules on FA across the EC is also an issue for consideration. Since this thesis is only meant to examine the research question from a legal point of view, no extensive discussion will be carried out over the content of the formula factors. Still though, some thoughts will be made on the future of the ‘Massachusetts’ Formula’, being a standard in the US.

In connection with the administration of the system, a number of topics relevant to compliance and enforcement will be analysed. Specific focus will be placed on proposing an effective and workable framework for the settlement of disputes. In a group taxation system extending beyond a single jurisdiction, fiscal disputes are expected to give rise to challenges. Thus, disagreement will not surface only between taxpayers and the Member States but also in a Member State to Member
State context. The latter should notably be expected to arise between a parent entity’s state and any of the subsidiaries’ states.

The thesis does not deal with tax abuse matters. This became clear in the course of research that a comprehensive approach to tax avoidance in a group taxation scheme is itself a distinct area. That normally extends beyond a single chapter and should therefore be a separate research project.

**Methodology**

This thesis is almost exclusively based on a bibliographical research of primary and secondary resources.

The former includes numerous policy documents of the European institutions in company taxation and also the documents of the Working Group on the CCCTB project. By way of background, the jurisprudence of the ECJ is also extensively discussed to the extent that it bears a relevance to group taxation. In specific parts\(^\text{16}\), there is also reference to a smaller amount of case law by the US Supreme Court and few US State Courts. That is limited to the fields where the US federal tax system or certain state systems are used as comparators to a potential EC scheme. Where necessary, legislation is also cited. This extends beyond national parliamentary acts and EC Directives and Regulations. Thus, it also includes administrative measures. The most illustrative case in this thesis is the short references made to some US

\(^{16}\) More precisely, those parts are: (i) The discussion on the Commerce and Due Process Clauses at Chapter 3, Part C, Section II; (ii) The definition of a unitary business at Chapter 6, Part A, Section III; (iii) The discussion on the Uniform Definition of Income for Tax Purposes (UDITPA) at Chapter 7, Part C, Section I; (iv) ‘water’s edge’ in the US at Chapter 8, Part A; and (v) Formulary Apportionment (FA) in the USA at Chapter 9, Part B, Section I.
unitary states' administrative regimes in connection with return filing, the taxable periods and registration.\textsuperscript{17}

In terms of secondary materials, a large number is relevant to EC institutional matters. Another part touches on EC Tax Law and primarily focuses on the ECJ's jurisprudence. Further, since the US is a comparator country in this thesis, it is normal that extensive US literature, mainly derived from law reviews, features highly in the text.

Conclusions on the structural components of an EC-wide group taxation scheme have been reached through assessing input derived from the company tax systems of three countries. That is, Canada, Switzerland and the US. The decision to focus on these systems has been a result of the following series of thoughts:

(i) The data should be relevant to the peculiarities of charging corporation tax at sub-federal level. It may be true that a system of group taxation applying across the EC will consist of a single tier at which tax is levied. This is due to the fact that no central authority is furnished with taxing powers in the EC. Still though, sub-federal schemes are highly relevant to an EC project because formulary apportionment (FA) is a common feature of both. Thus, the taxing claims over a group tax base are due to be shared by apportionment rather than through international tax norms of source/residence.

(ii) The jurisdictions used as comparators were chosen following initial research.\textsuperscript{18} The aim has been to identify legal systems which apply corporation tax at sub-

\textsuperscript{17} Chapter 5 contains information on certain features of the administrative laws and practices of the following unitary US States: California, Illinois, New York and Texas. It should be noted that it has been very difficult to trace information in this field. The web-pages of state revenue authorities on the internet have been the only source to derive data from. Still though, that was made available in a fragmented manner, which rendered systematic research impossible. Taking this into account, the information found is used in this thesis only for the purpose of supplementing other findings. It should definitely not be treated as a piece of comprehensive evidence.

\textsuperscript{18} Research also covered Australia, Brazil and Germany, which were not found to levy corporation tax at sub-federal level. The outcome of the research is also confirmed by documents on the prospect of implementing FA in the EC which also limit their survey to Canada, Switzerland and the US. Commission (EC), Report of the Committee of Independent Experts on Company Taxation (Office for Official Publications of the European Communities, Luxembourg 1992) Annexes 9A, B & C (henceafter The Ruding Report); JM Weiner, 'Formulary Apportionment and Group Taxation in the
federal level and allocate the taxable base by FA. The above states appeared the only major jurisdictions worldwide that fulfilled these criteria.

(iii) It is noteworthy that Canada and Switzerland do not operate group taxation systems. Inevitably, therefore, comparison of those two systems with the EC is limited to the general debate on harmonisation or de-regulation/tax competition and the sharing mechanism. In contrast, the US has a presence in different parts of the thesis where substantive elements of group taxation are discussed.

Comparative data on national group taxation systems is also given in specific parts of this thesis. In particular, these include: (i) the details of ownership tests for entitlement to group membership; (ii) the different ways to achieve tax base integration; and (iii) certain rules on administrative formalities, such as registration, the term of a group or return filing details. The comparative information was, in some cases, derived from the country surveys contained in one of the IFA Cahiers volumes of 2004\(^{19}\) and has been checked for updates.\(^{20}\)

Further, three major company law systems (i.e. the UK, France and Germany) are considered in the context of the control criterion for group membership.\(^{21}\) The specific choice of systems relied on the following:

(i) A presence of the common law tradition in the tests assessed, which is reflected in the UK;

(ii) The two continental systems (i.e. France and Germany) have been created throughout a long tradition in commercial law, which has had a definite influence on the remaining civil law jurisdictions.


\(^{20}\) The key changes involve the enactment of new group taxation systems in Italy and Austria. Both systems accommodate a cross-border dimension. The Austrian system gave way to Organschaft in favour of consolidation. For details, see later in the thesis at: Chapter 6, Part A, Section I.

\(^{21}\) See later in the thesis at: Chapter 6, Part A, Section II.
It should also be noted that, at the early stages of research, a meeting was held with relevant staff at the European Commission and discussed broadly the imminent and ongoing company tax projects.\textsuperscript{22} Over the session, more weight was placed on the CCCTB initiative. Clarification was also given on how simultaneous work on ‘comprehensive’ and ‘targeted’ approaches to company taxation fit together. Much of the information collected over this meeting was made available online, through the documents of the Working Group on the CCCTB, shortly later. The meeting was helpful in advancing the research process at the time it was held. However, the results do not contain new data; that is, namely, items not otherwise considered through later official documents. This is why no separate section in this thesis will be dedicated to analysing the outcome of the meeting with the Commission.

\textit{An Outline of the Chapters}

This thesis comprises nine chapters. Its core develops throughout the five substantive chapters (i.e. 5-9). Chapter 5 sheds light on the administration of the scheme whilst the remaining four delve into one group element each.

It should be noted that 1\textsuperscript{st} July 2007 is set as a cut-off date for this thesis, which means that developments occurring later than that date are not covered.

The first two chapters set the background of the analysis. That is namely the jurisprudential and legislative framework of the EIM within which any potential group taxation project should develop.

\textsuperscript{22} The meeting was held on 28\textsuperscript{th} November 2005 in the building of the Directorate General for Taxation and the Customs Union (DG TAXUD).
The third chapter provides surveys of the tax systems of Canada, Switzerland and the US with a particular focus on the principles pertaining to the division of power between the federal and sub-federal tiers.

Chapter 4 briefly presents and debates the policies for corporate taxation in integrated markets. An attempt is made to answer whether regulation should be treated as a prerequisite for corporate tax coordination in the EC. Finally, the objectives of the EIM and possible instruments leading to their attainment are placed within the framework of an EC-wide group taxation scheme.

Chapter 5 classifies the issues relevant to the administration of the scheme into four categories: compliance, enforcement, dispute resolution and re-assessment of tax liability. The unique constitutional structure of the EIM cannot easily be linked – not even indirectly - to a precedent from which examples can be derived. So, especially the part on dispute resolution is more about setting the principles for a new structure rather than proposing adjustments to existing schemes.

Chapter 6 aims at setting forth a test for entitlement to group membership. It should be stressed that this thesis does not feature any analysis on the types of entities to be allowed group membership. Instead, it is only concerned with tests that determine the appropriate degree of affiliation among potential group members. The reason for this policy choice is only a practical one. A comprehensive analysis of the eligible types of entities cannot be limited to the contours of a section in a thesis’ chapter. In contrast, this can be a separate piece of research on its own, as it requires extensive comparative work coupled with a study of tax avoidance challenges.

Chapter 7 focuses on tax base integration. This thesis takes an approach in favour of a broad definition which does not introduce distinction between business and non-business income.
The territorial delineation of the group is explored in chapter 8. The discussion kicks off from the assumption that ‘water’s edge’ is applicable. Based on that, this thesis examines the interaction between FA and the international tax law principles of source/residence. The analysis concentrates on the legal matters which attach to crossing the ‘water’s edge’. Not all possible corporate structures have been considered. This is because, in most cases, reaching a decision on which schemes qualify for the EC-wide group taxation system is purely a matter of policy choice with no bearing on the legal front.

Finally, chapter 9 explores FA. The specific formulation of the mechanism for apportionment is normally an economists’ responsibility. Therefore, the focus of this thesis is on the legal aspects of group taxation, rather than on economics-based analysis of the formula used for apportionment.

The aim of this thesis is to discuss the structural elements of groups without analysing the content of individual features in detail. The latter would be an investment in the wrong direction at this stage. Thus, newly-created schemes first need to be given shape; this can normally be achieved through consideration in a broader context. It is that framework which is the focus of this thesis.
1. THE JURISPRUDENCE OF THE ECJ RELEVANT TO GROUPS

Introduction

The project of the Internal Market in the field of direct taxation has primarily been brought forward through the case law of the ECJ. Only few legislative initiatives have reached success over the past fifty years. The reason has largely been the unanimity rule\(^23\) which consistently causes deadlock at the Council.

The aim of this chapter is to focus primarily on the aspects of the ECJ's case law which are of relevance to MNEs within the EIM. Enacting legislation normally involves comprehensive regulation in a specific field. This is clearly a more far-reaching effect than that created by the Court's jurisprudence since the latter may only rule on the specific facts brought forth for adjudication. Still though, knowledge of the case law is an essential background to positive integration initiatives. This is because all EC secondary legislation is judiciable before the ECJ and should therefore comply with its rulings.

The analysis is divided into two parts: (A) an outline of the main principles established through the ECJ's case law; (B) an examination of selected areas which, for the purposes of this work, have been categorised into four fields: (i) distributions; (ii) group loss relief; (iii) the treatment of permanent establishments (PEs) by the host state; and (iv) intra-group asset transfers. It should be noted that the

\(^{23}\) TEC art 94.
jurisprudence on anti-avoidance (i.e. CFCs, Thin Capitalisation and Transfer Pricing) is not covered in the analysis that follows. The reason is that, in line with the research objectives set out in the Introduction, this thesis will not touch upon matters of tax abuse relevant to groups.

Part A: The Principles

I. The Concepts of ‘Allocation’ and ‘Exercise’

The jurisprudence of the ECJ confirms Member States’ sovereignty in tax matters and makes an attempt to define the limits placed on that by the EC Treaty. This is illustrated in the following quotation, which appears in almost every tax ruling:

...it should be noted that, according to settled case-law, although direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with Community law ........ and avoid any discrimination on grounds of nationality...24

The above alludes to the distinction between two fundamental concepts which delineate the contours of ECJ’s jurisprudence in direct taxation:

(i) The ‘allocation’ of taxing power among the Member States falls under their exclusive competence. Further, it is not reviewable by the ECJ for conformity with the Freedoms.
(ii) The ‘exercise’ of allocated tax jurisdiction, which should comply with the Freedoms of the EIM, as construed in the EC Treaty and through the ECJ’s case law.

In the context of an EC-wide group taxation scheme, clarifying the limits of the EC Treaty is vital in delineating what can be subjected to the scrutiny of the ECJ.

Gilly\(^{25}\) is the landmark case in connection with ‘allocation’. It contains acknowledgment that it is ‘the contracting parties’ competence to define the criteria for allocating their powers of taxation as between themselves, with a view to eliminating double taxation’.\(^{26}\) In principle, the rule should be that the ‘allocation’ of tax jurisdiction falls outside the ambit of the EC Treaty. Therefore, no discussion of discrimination/restriction can be relevant.

The validity of the above position has recently been confirmed by the ECJ in two of its rulings on dividends (i.e. \textit{ACT IV GLO}\(^{27}\) and \textit{Denkavit France}). Both cases dealt with the tax treatment of recipients of foreign-source dividends in the state of source. More specifically, the Court treated the non-resident recipient’s subjection to a tax charge as a prerequisite for comparability.\(^{28}\) That is, if the state of source were found to have exercised no tax jurisdiction over the non-resident taxpayer, the facts would not be reviewable for compliance with the Freedoms. Indeed, the ECJ arrived at different conclusions in each of the two cases. Namely, in \textit{ACT IV GLO}, it was found that the imposition of ACT on a distribution did not qualify as a tax charge.\(^{29}\) By contrast, the ruling in \textit{Denkavit France} confirmed that an exercise of tax jurisdiction over the non-resident taxpayer had taken place.\(^{30}\)

\(^{24}\) Case C-170/05 \textit{Société Denkavit International BV and Denkavit France Sarl v Ministre de l'Économie, des Finances et de l'Industrie} [2006] ECR I-11949 para 19 (hereinafter \textit{Denkavit France}).

\(^{25}\) Case C-336/96 \textit{Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas-Rhin} [1998] All ER (EC) 826, [1998] 3 CMLR 60 (hereinafter \textit{Gilly}).

\(^{26}\) ibid para 30.

\(^{27}\) Case C-374/04 \textit{Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue} [2006] ECR I-11673 (hereinafter \textit{ACT IV GLO}).

\(^{28}\) ibid paras 52 and 56; \textit{Denkavit France} para 35.

\(^{29}\) \textit{ACT IV GLO} para 56.

\(^{30}\) \textit{Denkavit France} para 37.
The above judgments reaffirm the principles set out in *Gilly*. This could indicate that the ECJ has remained firm to the fundamental concepts of its jurisprudence over the years. The truth, though, is that the accuracy of any such statement can be challenged, especially in light of the ruling in *M&S*\(^{31}\) and *Ritter Coulais*\(^{32}\). In the aftermath of those judgments, the distinction between ‘allocation’ and ‘exercise’ cannot be defined on absolute terms any longer.

The outcome of *M&S* was to place the allocation of taxing power - even within a very limited scope - under the scrutiny of EC Law. This is clearly irreconcilable with *Gilly*. Briefly, the Court found that, where consideration of losses in the state of source has been rendered impossible, the origin state should take action to provide relief. This was so, regardless of the absence of origin-state jurisdiction to tax the revenue out of which the losses arose. It may thus be held that the ruling amounts to subordinating the Member States’ competence to allocate taxing jurisdiction to the review of the ECJ.

A case highlighting grey areas in the distinction between ‘allocation’ and ‘exercise’ is *Ritter Coulais*. Germany was called upon to consider ‘negative income’ (i.e. losses) deemed to have arisen from property held in another Member State. Pursuant to the Franco-German DTC, Germany was entitled to take account of revenues earned from property located in France in determining the tax rate applicable to its residents. The facts of the case did not, however, involve property letting, which would produce positive income. By contrast, the taxpayers made self-use of the house as a dwelling. In a domestic context, they would have been entitled to take account of a deemed loss in computing their income tax rate. However, under the DTC, that facility did not extend to property located in the other contracting state. That was found by the ECJ to infringe the Free Movement of Workers (TEC arts 39

\(^{31}\) Case C-446/03 *Marks & Spencer v David Halsey (HM Inspector of Taxes)* [2005] ECR I-10837 (hereinafter *M&S*).

\(^{32}\) Case C-152/03 *Hans-Jürgen and Monique Ritter-Coulais v Finanzamt Germersheim* [2006] ECR I-01711 (hereinafter *Ritter Coulais*).
et seq.). Consequently, Germany was condemned to take account of the losses, despite the DTC provisions.

In this case, Germany was entitled by the DTC to relieve positive income earned from foreign-located property through exemption with progression. It did not impose any tax charge on the relevant amounts. On that basis, the consideration of 'negative income' affected the allocation of taxing jurisdiction between the two states. Still though, the amounts could possibly qualify as an indirect tax charge, since, through progression, they contributed to determining the tax rate applicable at residence. If this second interpretation were endorsed, then no issue of EC Law interference with the concept of 'allocation' would come to the fore.

II. The Test for ‘Equal Treatment’

A group taxation scheme applying uniform rules across the EC is not likely to raise issues of discrimination or restriction internally. Further, it will be explained in Chapter 7 that, in its alternative version of HST, the scheme should not run a risk of being found discriminatory/restrictive. However, equal treatment is of relevance when it comes to relations between group entities and EC-resident non-affiliates. Still though, comparability of situation should be established before arguments of discrimination/restriction can be advanced. That can be hard to sustain, especially when a difference in treatment is grounded on the degree of affiliation.

(i) Discrimination or Restriction?34

33 Chapter 7, Part B, Section I.
The test is applied once it is concluded that the facts of the case involve the 'exercise' of taxing jurisdiction and, therefore, fall within the scope of the freedoms. The relevant provisions of the EC Treaty lay down the foundation stones of the EIM. Based on that assumption, they have been broadly construed by the ECJ. It is settled jurisprudence of the ECJ that findings of Treaty infringement may be made on a ground of either discrimination or restriction. Each time, connection should be built with the specific freedom at stake. Further, there are few default provisions in the EC Treaty: Arts. 3(1)(c) (abolition of obstacles to the Freedoms), 12 (discrimination by reason of nationality) and 14(2) (definition of the EIM). Article 12 should, in principle, be employed, as a legal basis, in conjunction with one of the Freedoms and not individually.\(^{35}\)

Discrimination could generally be defined as the outcome of treating equivalent situations in a dissimilar manner or, conversely, different situations similarly. The test on discrimination is normally structured as a comparison between a domestic situation and its equivalent cross-border one, resulting in a disadvantageous treatment of the latter. If comparability cannot be sustained, then differential treatment shall be allowed. The most frequently stated example of incomparability is between the situations of residents and non-residents. It was put forward in Schumacker\(^{36}\) for the first time, and ever since has been made the starting point in many judgments.

Two forms of discrimination have been identified by the jurisprudence of the ECJ: overt/direct and covert/indirect discrimination. The former concerns discrimination by reason of nationality which may only escape illegitimacy through grounds for

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\(^{35}\) This is implicitly derived from Schump: Case C-403/03 Egon Schump v Finanzamt München [2005] ECR I-6421 para 15 (hereinafter Schump).  
justification explicitly mentioned in the EC Treaty.\footnote{For instance, the prohibition of all discrimination based on nationality between workers of the Member States may be limited by virtue of justifications on grounds of public policy, public security and public health (TEC art 39(2) & (3)).} Covert/indirect discrimination, recognised since 1974\footnote{Case 152/73 Giovanni Maria Sorgin v Deutsche Bundespost [1974] ECR 153 (hereinafter Sorgin).}, makes use of criteria for differentiation, other than nationality, which in fact lead to the same result.\footnote{Ibid para 11.} Here, the most common discriminatory criterion is residence, as most residents in a Member State are also nationals of that state. The crucial difference between the above two types of discrimination lies in the fact that covert discrimination is justifiable on grounds of the rule of law.\footnote{This is the so-called Cassis justification: Case 120/78 Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein [1979] ECR 00649 (Cassis de Dijon) paras 9-14 (hereinafter Cassis).} Thus, there is no requirement that those grounds are expressly derived from the wording of the EC Treaty.

Restriction, pointing to a second generation of cases, is a broader concept. It illustrates the existence of an obstacle which hinders/discourages intra-EC, as opposed to domestic, commercial activity.

A comparison between domestic and similar cross-border facts may, in cases, be present implicitly, even within a setting of restriction.\footnote{Case 81/87 R v HM Treasury, ex parte Daily Mail & General Trust Plc [1988] ECR 5483 (hereinafter Daily Mail); Case C-264/96 Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes) [1998] ECR 1-04695 (hereinafter ICI); M&S, Case C-436/00 X and Y v Riksskatteverket [2002] ECR 1-10829 (hereinafter X and Y).} For instance, such a comparison could clearly be drawn in M&S, a case involving restriction considered from an origin-state viewpoint. The two sides dealt with the treatment of losses incurred by group subsidiaries domestically and across border.

It still is possible, though, that an obstacle case is sustained without bringing in any comparison. That is, a restriction arises out of a situation which simply deals with ‘measures applicable without distinction’\footnote{Case C-80/94 G. H. E. J. Wielocks v Inspecteur der Directie Belastingen [1995] ECR 1-2493 (hereinafter Wielocks).} (even-handed rules). The measures
should have the effect of impeding/discouraging the exercise of the EC Fundamental Freedoms. This is a typical structure of restriction case.

Bosman\textsuperscript{43}, a non-tax case, led the way here. The ‘transfer, training or development fee’\textsuperscript{44} payable upon a football player’s transfer into a new sport club was equally due in both domestic and cross-border transactions. No difference in treatment was identifiable between the two. Yet, the fee due was treated as an illegitimate charge which amounted to an obstacle in the EIM. A breach of TEC art 39 on the free movement of workers was established. It follows, therefore, that the prohibition of discrimination is coupled with the more far-reaching concept of restriction which broadens the ambit of the freedoms.

(ii) The Origin and Host State

Direct tax cases on discrimination/restriction which reach the ECJ normally deal with facts considered from the perspective of either an origin state or a host state. The commercial activity under scrutiny should have a Community element to qualify as an exercise of the EC Treaty freedoms. Thus, a purely domestic dimension does not bring a case within the scope of EC Law.

The origin state is often attached to a comparison taking the form of a ‘migrant/non-migrant’ test.\textsuperscript{45} The comparators are two nationals (or residents) of a Member State, one of whom crosses the border to become commercially active abroad. In principle, that is in another Member State. The extent – if any – of relevance of the Freedoms to a third-country context has not yet been clarified by the ECJ. Examination of a

\textsuperscript{43} Case C-415/93 (i) Union Royale Belge des Sociétés de Football Association ASBL v Mr Bosman (ii) Royal Club Liégeois SA v Mr Bosman, SA d’Économie Mixte Sportive de l’Union Sportive du Littoral de Dunkerque, URBSFA and Union des Associations Européennes de Football (UEFA) (iii) UILFA v Mr Bosman [1995] ECR I-04921 (hereinafter Bosman).

\textsuperscript{44} ibid para 114.

case from an origin-state perspective means that the comparison will place the fiscal situation in that state as the point of reference. Namely, it should juxtapose the tax treatment at home of a taxpayer establishing, investing or providing services domestically to that of another who engaged in the same actions elsewhere in the EC. The case may involve either discrimination or restriction. The state of origin is always in the position of what is defined as ‘residence’ in International Tax Law (i.e. where final tax liability arises).

Cases considered from a host-state viewpoint may deal with the tax status of a non-resident EC taxpayer who becomes engaged in commercial activity in the host state. To establish discrimination, a comparison often needs to be drawn. In that process, the tax treatment reserved to residents being in similar circumstances is taken into account. An issue has lately come to the fore in relation to the structure of this comparison. The recent judgments in ACT IV GLO and Denkavit France placed a requirement that the non-resident taxpayer’s final tax liability be considered in deciding on the existence of breach. A host state is the state of source in international tax.

It is noteworthy that identifying the origin and host states may not be a straightforward process within a group taxation system applying across border. It will be explained later in this thesis that certain intra-group transactions are meant to be eliminated. Further, the group tax base will be allocated to eligible jurisdictions by apportionment, which eliminates links to the concepts of source and residence.

(iii) Grounds for Justification


46 This approach and its potential implications will be discussed in detail later in this chapter in Part B, Section I.
A finding of discrimination or restriction may not lead to infringement of the EC Treaty if it is ‘objectively justified by an overriding reason in the public interest.’ This statement appears in the vast majority of ECJ’s rulings containing analysis on justification. It is based on the rule of reason, which implies that it may only be used in cases of covert discrimination and of restriction. A brief outline of justification arguments, often raised in direct tax cases, is given below. Discussion will not extend to further analysis, as it is only marginally relevant to this thesis.

Various grounds for justification have been proposed in the field of direct taxes. The ECJ has consistently rejected a couple among them. For instance, the risk of revenue loss has never been accepted as a valid justification. Further, coherence, despite being extensively used as a ground for justification, has not proved successful for Member States in the vast majority of cases. By contrast, tax avoidance and the effectiveness of fiscal supervision are, in principle, admissible arguments. Yet, those are often found disproportionate to the aims they pursue and are ruled out to be replaced by less restrictive measures. Territoriality was a successful ground in Futura but failed in Bosal, M&S and Rewe Zentralfinanz. Finally, the risk of double-dip in the case of losses and the so-called ‘balanced allocation of taxing power between Member States’ have featured in the corporate cases of M&S, Oy AA and Rewe Zentralfinanz.

(iv) Situations Engaging Third Countries

48 So far, the only successful tax case has been Bachmann: Case C-204/90 Hanns-Martin Bachmann v Belgian State [1992] ECR I-00249 (hereinafter Bachmann).
50 Ibid para 22.
51 Bosal paras 37-38.
52 M&S paras 36-40.
FII\textsuperscript{55} is the first case in direct taxation where the ECJ expressly acknowledged that TEC art 56(1) on the Free Movement of Capital extends its benefits to third countries. This was directly confirmed in Holböck\textsuperscript{56}. It could also be claimed that FII has been indirectly approved by Thin Cap GLO\textsuperscript{57}, Lasertec\textsuperscript{58} and A and B\textsuperscript{59}.

Up until FII, there was no certainty about whether the free movement of capital was applicable in fiscal relations with third countries. The wording of TEC art 56(1) may seem straightforward but the situation remained vague. This is noteworthy, considering that, outside taxation, such extension has been settled case law of the ECJ since the 1990s.\textsuperscript{60} In taxation, indirect references\textsuperscript{61} to the matter were made occasionally but they pointed to nothing substantial. In principle, the position was in favour of considering intra-EC transactions in a different context from transactions with third countries. Thus, in Manninen, it was explicitly held that the freedom did not require that third-country situations be treated under the same terms as capital movements between Member States. Further, van Hilten\textsuperscript{62} turned down the expectations for a landmark ruling.

In the aftermath of FII, the scope of the free movement of capital remained unclear. The Court made a finding of restriction\textsuperscript{63} but did not clarify under what terms third

\textsuperscript{54} Case C-231/05 Oy AA v Keskusverolautakunta [2007] ECR I-00000 (hereinafter Oy AA).
\textsuperscript{55} Case C-446/04 Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue [2006] ECR I-11753 (hereinafter FII).
\textsuperscript{56} Case C-157/05 Winfried L. Holböck v Finanzamt Salzburg-Land [2007] ECR I-00000 para 31 (hereinafter Holböck).
\textsuperscript{57} Case C-524/04 Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue [2007] ECR I-00000 paras 33-34 in conjunction with 101 (hereinafter Thin Cap GLO).
\textsuperscript{59} Case C-102/05 Skatteverket v A and B [2007] ECR I-00000 para 27 (hereinafter A and B).
\textsuperscript{61} Lenz para 17; Manninen para 51 & A.G.’s Opinion para 79.
\textsuperscript{62} Case C-513/03 Heirs of M. E. A. van Hilten-van der Heijden v Inspecteur van de Belastingdienst [2006] ECR I-01957 (hereinafter van Hilten).
\textsuperscript{63} FII para 168.
countries are entitled to protection. That is, whether the scope of the free movement of capital should be downsized vis-à-vis third states. One matter that seems to have been solved concerns the overlap between the two freedoms: establishment and capital. It is now certain that establishment does not extend to third countries through its possible overlap with capital. The concept of ‘overlapping area’ also seems to have been renounced, as the Court lately insists on the applicability of only one freedom each time. In identifying the applicable freedom, it is crucial to conclude which concept is targeted by the restriction and which is merely an inevitable consequence of the former.

It could be expected that capital is interpreted restrictively vis-à-vis third countries. An indication may be the reference made by the ECJ to the Exchange of Information Directive. It is thus acknowledged that taxing intra-EC economic activities may be incomparable to taxing equivalent activities in a Member State – third-country context. This is due to the degree of integration within the EC, being the result of the existence of common rules in specific areas. The Directive on the Exchange of Information is an example of this.

It is interesting that, in FII, the Court in principle accepted the argument of the UK referring to the above Directive and rejected it only on proportionality grounds. Judging from this approach of the ECJ, an attempt could possibly be made to speculate on future developments in the field. It cannot be excluded that the ECJ restricts the third-country aspect of TEC art 56(1) through the use of arguments touching upon the exchange of information. Indeed, most DTCs that follow the OECD Model contain a provision on the exchange of information. Considering this, the ambit of the freedom vis-à-vis third countries could potentially be

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64 ibid para 165; Lasertec para 28; A and B para 29.
65 Thin Cap GLO paras 33-34; Lasertec para 28; A and B para 27.
67 FII para 170.
68 ibid para 172.
69 OECD Model Double Tax Convention (OECD Model DTC) art 26.
determined on a case-by-case basis, depending on the content of the specific DTC clause. It is also probable that the national courts will be entrusted with the task to check whether a specific DTC allows a degree of exchange of information equivalent to that of the EC Directive.

Further development is now anticipated in the pending case of C-101/05.70

If the ECJ had found in favour of the existence of an overlapping area between establishment and capital, that would have had a large impact on groups. In such a case, a group limited to the territory of the EC would be likely to create a discriminatory/restrictive setting in connection with third-country affiliates. Leaving those entities outside the group would place them in a disadvantageous position, as compared to the ones resident in the EC.

Part B: The Specific Areas

The discussion of ECJ’s jurisprudence which follows is intended to give an outline of the key issues being of relevance to groups of companies. Analysis is not meant to be comprehensive, since this chapter only aims at setting the background of where we stand, by virtue of the case law, in corporate taxes at EC level.

I. Distributions

70 Case C-101/05 Skatteverket v A Reference OJ C 106, 30 April 2005 (pending).
The treatment of cross-border dividend distributions in a group taxation scheme extending across more than one jurisdiction requires specific adjustments. It should be decided which jurisdiction intra-group distributions have to be allocated to. Further, the treatment of inbound and outbound distributions, notably their incorporation into, or exclusion from, the group tax base, is another area which requires regulation. In both cases (i.e. intra-group and inbound/outbound distributions), compliance with the tests of ‘equal treatment’ may become an issue.

The Rules in the Origin State

Verkooijen is the first origin-state case which dealt with restriction arising from dividend distributions. Despite the Court having made an attempt to expressly limit the scope of its answer to individuals, Verkooijen indeed proved of a wider significance. The ruling is, therefore, of relevance to the field of corporate taxation. Further, the later judgments of Lenz and Manninen follow the same line of thinking. Finally, in the cases of Kerckhaert and Morres and FII, the Court delineated the scope of restriction. Limits were placed to what may qualify as Treaty infringement in inbound dividend distributions.

The first three cases (i.e. Verkooijen, Lenz and Manninen) share a common underlying feature. That is, they deal with schemes aimed at eliminating, or reducing, economic double taxation in dividend distributions. Within such a context, the question which came to the fore was whether a differential treatment of foreign-
source dividend payments is allowed by the EC Treaty. The rulings contain a restriction analysis from the perspective of the origin state.\(^{76}\)

In *Verkooijen*, the exemption, available to dividend recipients in a domestic context, was not extended to foreign-source distributions. In *Lenz*, a disadvantage arose against taxpayers, fully taxable in Austria, when receiving income from a foreign source. Namely, residents receiving domestic revenues could opt for a charge at either a fixed rate of 25 percent or the ordinary progressive rate reduced by half.\(^{77}\) By contrast, revenue from capital originating in another Member State was subject to the application of ordinary income tax, the rate of which may have been as high as 50 percent.\(^{78}\) Discrimination in *Manninen* arose from refusing extension of the imputation credit to foreign-source dividends. By contrast, domestic distributions benefited from an imputation credit intended to offset the corporation tax paid at company level.\(^{79}\) The effect was thus to eliminate economic double taxation in internal situations whereas the same was not the case for foreign-derived revenues.

The judgments delivered in the above cases are a straightforward demonstration of the ‘migrant/non-migrant test’, dealing with equal treatment in a context of restriction. The facts involved a comparison between the tax treatment of a domestic situation and of an equivalent cross-border one. The foreign element consists of a resident investing abroad; that is, in a company resident in another Member State. The rules in the cases mentioned put forward no discrimination on grounds of nationality or residence. Thus, both sets of the comparison involve residents in the origin state and the taxpayer’s nationality is irrelevant.

\(^{75}\) Case C-513/04 *M Kerckhaert and B Morres v Belgische Staat* [2006] ECR I-10967 (hereinafter *Kerckhaert and Morres*).

\(^{76}\) It should be mentioned that, in all three cases, reference is also made to an additional restriction. Thus, companies established in other Member States are faced with an obstacle to raise capital in the specific state where the dividends’ recipient is resident. The reason is that, due to the disadvantageous treatment of dividend distributions originating abroad, shares in companies residing in another Member State are less attractive to investors (*Verkooijen* para 35; *Lenz* para 21; *Manninen* para 23).

\(^{77}\) *Lenz* para 20.

\(^{78}\) Ibid.

\(^{79}\) *Manninen* paras 8-9.
The above rulings are typical examples of the practice of negative integration. Decision is based on the interpretation of the EC Treaty’s provisions on the Free Movement of Capital. The underlying objective is to achieve equal treatment. That is: since relief for economic double taxation is given domestically, it should also be extended to cases in which one invests across border (in another Member State).

The effect of applying the principle of equal treatment to the cases discussed above has been to extend relief for economic double taxation to intra-EC situations. That should not, however, be understood as a step towards a more integrated market functioning within a setting of neutrality of investment decision. Thus, a neutral environment should provide a framework for engaging into intra-EC commercial activity at no additional cost to that incurred in a domestic context. Clearly, this is not part of the concept of equal treatment. It is also illustrated by Advocate General Geelhoed, who explicitly distinguished between disparity and discrimination/restriction and excluded the former from the scope of the Freedoms.80 Cases Lindfors and Schenmp read:

…the Treaty offers no guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation.81

It follows that economic double taxation is allowed in intra-EC transactions, except for cases where:

(i) the Parent-Subsidiary Directive82 is applicable; or
(ii) there is a finding of unequal treatment between a domestic situation which relieves economic double taxation and a similar intra-EC one which deprives the taxpayer of such benefit.

80 ACT IV GLO paras 46-47.
Economic double taxation falls within the ambit of TEC art 293, which urges the Member States to enter into negotiations for the abolition of double taxation. However, any such claim cannot be brought before the ECJ on that legal basis, as the provision does not produce direct effect over taxpayers. Despite, therefore, the provision of TEC art 293, combating economic double taxation is primarily placed within the contours of the Freedoms. It may thus be a separate objective of the Treaty only within a framework of positive integration. Otherwise, the ECJ deals with double taxation as part of the requirement for equal treatment which points to an intergovernmental understanding of the EIM.

The more recent judgment in FII confirms the above thinking. It thus places (economic and juridical) double taxation within the context of equal treatment and distinguishes between allocation and exercise of taxing power:

The mere fact that it is for a Member State to determine for such holdings whether, and to what extent, the imposition of a series of charges to tax on distributed profits is to be avoided does not of itself mean that it may operate a system under which foreign-sourced dividends and nationally-sourced dividends are not treated in the same way.83

One of the questions discussed in FII concerned the compatibility with EC Law of the system of relief for double taxation.84 As expected, the facts of the case are examined from the viewpoint of the origin state. A number of conclusions were reached by the Court concerning the extent to which relief should be granted by the state of residence. The rulings delivered contained reference to equal treatment and to Member States’ sovereignty in tax matters.

One question dealt with relief given, domestically, for economic double taxation whereas only for juridical double taxation in intra-EC situations. It was found that

83 FII para 69.
84 ibid paras 33 et seq.
this amounts to unequal treatment.\textsuperscript{85} Such a national rule is, therefore, in breach of the Freedoms.

Another issue involved the amount up to which double tax relief should be granted by the state of residence. It should be noted that the facts concerned economic double taxation.\textsuperscript{86} The ECJ stayed firm to an intergovernmental approach to the Freedoms which, by effect, confirmed the absence of neutrality requirements. It was thus held that, in a credit system, the state of residence assumes no obligation to relieve beyond the amount of corporation tax borne by the dividends' recipient.\textsuperscript{87} This is in line with the position taken by the Court in outbound dividend distributions.\textsuperscript{88} In those cases, the exercise of tax jurisdiction by the state of source has been a prerequisite for placing an obligation for relief. Further, the judgment in \textit{FII} is also compliant with the position that becoming commercially active abroad does not guarantee that fiscal costs will be equal to those in internal dealings.

\textit{Kerckhaert and Morres} contributes an additional aspect to delineating the contours of equal treatment in inbound dividend distributions. This is a case of juridical double taxation which remains unrelieved following payment of dividends by a French company to Belgian-resident individuals. A tax rate of 25 percent applied to both domestic and foreign dividend distributions.\textsuperscript{89} The Belgium-France DTC provided for relief for the withholding tax imposed at the normal rate.\textsuperscript{90} That was, however, refused to the claimants because the benefit was withdrawn by the Belgian legislature unilaterally.\textsuperscript{91} By effect, Belgian-resident individuals investing in France had to bear a higher tax burden than those staying domestically.

The Court found that the facts did not point to unequal treatment. It sufficed that both internal and cross-border situations were subject to the same tax rate. The

\textsuperscript{85} ibid para 63.
\textsuperscript{86} ibid paras 51-52.
\textsuperscript{87} ibid para 52.
\textsuperscript{88} See the following Title entitled: \textit{Outbound Dividend Distributions}.
\textsuperscript{89} \textit{Kerckhaert and Morres} para 3.
\textsuperscript{90} ibid para 8.
additional tax burden suffered by those individuals who invested in France was an outcome of the absence of harmonisation in Member States' tax systems. It falls within the concept of allocation of Member States' taxing powers and confirms the absence of neutrality in the context of equal treatment and the Freedoms.

The outcome in Kerckhaert and Morres highlights one of the many impasses to which the system of the Freedoms may lead. It is thus clear\(^\text{92}\) that, where economic double taxation is eliminated domestically, the benefit should also be extended to intra-EC transactions. That triggers the following thought: where juridical double taxation is absent domestically (Kerckhaert and Morres), why should it be tolerated in distributions originating in another Member State?

Tackling double taxation in the EIM is a very complex matter; at its current state of integration, the market is full of such features. However, as those are mainly attributed to disparities among Member States' tax systems, they cannot be tackled through negative integration. This is because they involve regimes which, regardless of compatibility with the broader objectives of the EIM, are not in breach of the Treaty provisions. The ECJ may only act in a number of those cases and, more specifically, where there is an inconsistency with the EC Treaty. Otherwise, most of the above concerns can receive appropriate treatment only through positive integration initiatives. A group taxation scheme of consolidated base applying across the EC can provide solutions to double taxation complexities.

*Outbound Dividend Distributions*

\(^{91}\) ibid para 12.

\(^{92}\) Verkooijen; Lenz; Manninen; FII.
Discrimination or restriction in the field of outbound dividend distributions may concern either of the following: (i) the corporation tax liability of the distributing (subsidiary) company; or (ii) the tax treatment of the dividends’ recipient in the state of source. Cases under category (i) contain an examination of facts from an origin-state viewpoint. Category (ii) involves host-state situations. The discussion below will follow this classification.

(i) The tax position of the distributing subsidiary

The leading corporate authority in this regard is *Metallgesellschaft*. It involved a refusal by the UK Government to grant UK-resident subsidiaries of German-resident parents an exemption from Advance Corporation Tax (‘ACT’). That was an advance payment of corporation tax, which, up until 1999, was due upon dividend distributions. Under the UK group taxation system, no ACT was payable upon distributions between entities that had opted for the group income election. However, the election was made available only between entities resident in the UK. The argument set forth by the defendant UK Government pointed out that UK subsidiaries, held by foreign parents, were subject to UK corporation tax. So, in principle, they should be in a position to offset ACT payments against their annual corporate tax liability. Nevertheless, the Court found the scheme to be still disadvantageous vis-à-vis the foreign-held UK subsidiaries. The reason related to the cash-flow disadvantage, which was the result of exclusion from entitlement to a group income election. The Court found in favour of the UK subsidiaries and even opened up the way for remedies.

This case is significant because, together with *ICI*, it seems to have paved the way for *M&S*. Here, the ECJ did not go any further than in *ICI*. It certainly made no

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statement requiring an extension of the UK group income election across border. In a similar manner to ICI, the court was called upon to deal with domestic companies held by foreign-resident parents. Further, the specific factual setting of the case allowed the ECJ to avoid a debate on the prospect of cross-border group taxation. Namely, the matter in issue involved the tax treatment from a UK viewpoint (i.e. UK-resident subsidiaries and UK-derived benefits).

This is where the distinction must be drawn with M&S. Here, the tax liability of a UK parent was associated with an item of income (i.e. losses) generated across border. So, on this occasion, consideration of the cross-border situation could not be escaped. However, it should perhaps be noted that, even in Metallgesellschaft, the Court made a broader statement in rejecting cohesion as an argument for justification: ‘...refusal to allow resident subsidiaries of non-resident parents to make a group income election...’. That appears to be more than an exemption from ACT. Indeed, it envisages an extension of domestic group taxation systems to foreign entities.

(ii) The tax position of the recipient company

This is an area in which development in the case law took place exclusively in the 21st century. The framework has been formed by the ECJ’s judgments in ACT IV GLO and Denkavit France. Apart from the Court’s rulings, Advocate General Geelhoed’s Opinions have been of particular significance. Thus, interesting ideas were set forth on how equal treatment should be understood within the EIM when dealing with the status of a dividend’s recipient. The two cases contain a new structure of the tests on equal treatment. Namely, Treaty compatibility appears to

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95 Metallgesellschaft para 73.
have moved away from setting one single Member State as point of reference. That is, consideration is not limited to the recipient’s tax liability in the state of source. Rather, focus is now placed on its final tax liability, which inevitably brings the situation at residence into consideration before reaching a decision.

*Fokus*<sup>97</sup>, a case of the EFTA Court, preceded the above mentioned decisions of the ECJ. The outcome of this case has been striking and appears to have implicitly been denounced by the ECJ, which abstained from any reference to it. The facts involved a claim placed by a parent company to the host state for a tax credit. That was meant to offset the withholding tax due upon a dividend distribution. The Court found illegitimacy in excluding a non-resident parent company from the credit, otherwise available to resident recipients. There was, namely, an infringement of Article 40 of the EEA Agreement (free movement of capital). It followed that compliance with the EEA Agreement would require that the grant of relief should be extended to non-residents. In this, the EFTA Court took no account of the non-resident recipients’ final tax liability, which would require consideration of their fiscal obligations at home.

*ACT IV GLO* dealt, among other questions, with whether the Freedom of Establishment (or Free Movement of Capital) was breached by the UK provisions on ACT. More specifically, a tax credit equal to the amount of ACT paid by the dividends’ distributor was allowed to UK-resident recipients of the dividends. By contrast, the credit was, in principle, refused to non-resident recipients. An exception to this applied only where provision for a credit was incorporated into a DTC concluded between the UK and the state of residence of the dividends’ recipient.

The ECJ, in line with the Advocate General, established comparability between a resident and a non-resident recipient of the dividends, where the latter is subjected to

income tax in the Member State of source. The exercise of taxing jurisdiction over
the dividends' recipient by the state of source is consequently a prerequisite for
comparability. Otherwise, differential treatment is allowed.\textsuperscript{98}

In the particular set of facts, the Court found that UK legislation, making ACT due
upon dividend distributions, did not amount to a tax charge. That rendered the
situation between residents and non-residents incomparable, which implied the
unequal treatment was allowed.

In \textit{Denkavit France}, the Court followed the principles set out in \textit{ACT IV GLO}.
However, in this case, the facts allowed comparability to be established. That led to
a finding of discrimination. Comparability was premised on the finding that the
imposition, by France, of a tax charge on dividend distributions could be sustained.\textsuperscript{99}
This has been the crucial point of distinction from \textit{ACT IV GLO} where differential
treatment was allowed in the absence of a tax charge.

Comparability allowed the comparison to be drawn, for the purpose of reaching a
conclusion on whether there was unequal treatment. The two ends were, on the one
hand, the position of a French-resident dividend recipient and, on the other, a
recipient resident in the Netherlands. Both received dividends derived in France. The
outcome was to find the French regime applying to dividend distributions
discriminatory. Consequently, to the extent that the relief granted domestically was
not made available to non-resident recipients, the latter were discriminated against.

To the end of reaching conclusion on discrimination, both \textit{ACT IV GLO} and
\textit{Denkavit France} discuss the process to be followed.

\textsuperscript{97} Case E-1/04 (EFTA Court) \textit{Fokus Bank ASA v The Norwegian State, represented by the
Directorate of Taxes} of 23 November 2004 (hereinafter \textit{Fokus}).
\textsuperscript{98} \textit{ACT IV GLO} para 68.
\textsuperscript{99} \textit{Denkavit France} paras 36-37.
In the former, the ECJ, having already established incomparability, the analysis was of theoretical value only. It was, thus, left to the national court to determine whether a tax charge imposed on the dividends’ recipient complies with equal treatment.\textsuperscript{100} The Court clarified that it does not suffice to consider the fiscal situation in the state of source. Instead, referring to Bouanich\textsuperscript{101}, it explained that DTCs in force between the Member States of source and residence should also be examined.\textsuperscript{102} The aim should be to make use of possible tax relief allowed at DTC level. Indeed, the A.G. noted that unequal treatment would be eliminated if the state of residence, in a DTC context, relieves ‘economic double taxation resulting from the imposition of ACT and UK income tax’.\textsuperscript{103}

In Denkavit France, the Court looked at the DTC between France and the Netherlands. Yet, a step further was taken here, compared to ACT IV GLO. That is, the relevant Netherlands’ legislation\textsuperscript{104} was additionally checked to ensure that no relief was provided unilaterally. The outcome has been as follows. The Netherlands exempted foreign dividends. That did not allow tax withheld at source to be relieved by the state of residence - either under the DTC or unilaterally.\textsuperscript{105} Therefore, following consideration of the payee’s final tax liability, the discriminatory result remained. Consequently, the Court placed the burden of rectifying discrimination onto the state of source.

To sum up, the test for equal treatment developed in the two ECJ cases on dividends is essentially the following: where a Member State charges income tax on dividend distributions to non-residents, whereas not on distributions made to residents, it bears the obligation to rectify unequal treatment. To decide on the existence of unequal treatment, it should be examined whether (or, to what extent) inequality is

\textsuperscript{100} ibid para 71.

\textsuperscript{101} Case C-265/04 Margaretha Bouanich v Skatteverket [2006] ECR I-00923.

\textsuperscript{102} ACT IV GLO para 71.

\textsuperscript{103} ibid (A.G.’s Opinion) para 89.

\textsuperscript{104} ibid para 47.

\textsuperscript{105} ibid para 46.
relieved by the state of the recipient’s residence. Thus, the test is structured on the
premise of the following:

(i) There is a requirement that taxing jurisdiction has been exercised over the non-
resident taxpayer. That is a condition for establishing comparability between
resident and non-resident recipients. It could be asserted that, placing one single
requirement for comparability (i.e. tax charge), creates a broad test.

In any case, ever since the ‘Avoir Fiscal’ line of cases, criteria for comparability
have been relaxed. It was then required that identical rules exist for computing the
tax base. In more recent source-state cases, though, such as Asscher and Gerritse, a
change in the above strict construction appears to have occurred. The mere fact of
engaging into commercial activity at source seems to suffice for entitlement to a tax
treatment equal to residents. In Fokus, the EFTA Court extended comparability to
holdings. Citing RBS, it made the following bold statement:

...the mere fact that the resident shareholders have general tax
liability in Norway while non-resident shareholders are
subject to tax in Norway only with respect to profits which
they earn there, is not sufficient to prevent the two categories
from being considered as comparable situations.

(ii) The test involves a computation of the non-resident’s final tax liability in
connection with the distribution in question. It thus consists of examining both DTC
provisions and unilateral domestic measures of the state of residence.

The judgments in ACT IV GLO and Denkavit France do not deal with the possibility
of absence of a DTC. It is not, therefore, certain whether, in that case, domestic law
in the state of residence should still be considered on an individual basis. Yet,
arguments in favour of an affirmative answer could be derived from the Court’s

106 ACT IV GLO paras 56 & 61; Denkavit France para 36.
107 Case C-270/83 Commission of the European Communities v French Republic [1986] ECR 273
(hereinafter ‘Avoir Fiscal’).
108 Fokus paras 29-30.
approach to the two already decided cases. In the *Denkavit France* decision, delivered two months after *ACT IV GLO*, the ECJ was indeed explicit in stating that domestic provisions of the state of residence should be considered.\(^{110}\) In that way, the Court went further than the Advocate General, who did not expressly refer to domestic law of the state of residence ("pursuant to the applicable DTC, or otherwise").\(^{111}\)

The recent judgments on dividends put forward new tests on equal treatment. They illustrate that traditional rules of interpretation fail to provide solutions when it comes to the status of non-residents. The new scheme, in principle, confirms the inter-governmental nature of the comparisons attached to the Freedoms. In addition, it respects the allocation of taxing jurisdiction, as determined by the Member States of source and residence. Namely, the state of source has to adjust its rules to rectify unequal treatment of non-residents only when relief at residence does not offset the disadvantage at source.

II. Group Loss Relief

An EC-wide group taxation system of consolidation allows loss-making group members to surrender their losses to profitable group entities. That is an immediate outcome of consolidation. In light of this, an outline of the current situation in connection with loss relief is useful in identifying the ‘restriction’ that the EIM is being faced with. This is a background to any positive integration initiative launched to remedy complexities. The judgment in *M&S* is the focus in outlining the regime of losses in the EC.

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\(^{109}\) ibid para 29.

\(^{110}\) *Denkavit France* para 47.

\(^{111}\) ibid A.G.’s Opinion para 52.
A. Domestic Group Losses in a Multinational Consortium Structure

The way to M&S, the landmark case on group loss relief, was opened up in the late 1990s by ICI. ICI concerned group relief within a consortium of companies of which the majority were resident outside the UK. However, complex issues, such as those relating to the allocation of taxing powers and taxing jurisdiction in the EIM, were not raised. The claim involved transfers of losses between members of the consortium which were all resident in the UK. The case was solved through mainstream argumentation on infringement of the Freedom of Establishment caused due to inequality of treatment. Still though, the key point has been that the idea of making loss relief available within a multinational consortium was broadly considered for the first time. Further, a facet of the repercussions of ICI was the UK Finance Act 2000, which extended the UK Group Relief to losses surrendered by UK-located PEs of group companies resident in other EC Member States.

B. Consideration of Foreign Group Losses: the M&S Litigation

M&S has been one of the most extensively discussed litigation cases in direct corporate taxes. It probably attracted a ‘public eye’ more than any other tax case before the ECJ. The decision was issued on 13th December 2005. Further, the

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Opinion of the Advocate General was delivered half a year earlier (7th April 2005), just two months after the hearing.

Briefly, M&S challenged the compatibility of the UK group taxation system ("loss relief") with the EC Treaty Freedom of Establishment. The facts of the case concerned the utilisation, by a UK-resident parent company, of losses incurred by companies of the group in other Member States (i.e. Germany, France and Belgium). The UK group taxation system granted loss relief through transfers of losses. Those were allowed among companies resident in the UK or, since April 2000, UK-located PEs of EC-resident group companies.

Two grounds were put forward by the claimants to support their allegations of EC Law infringement: (i) a UK-resident parent is entitled to consider UK-resident subsidiary losses whereas this is not possible if a subsidiary is resident in another EC Member State; (ii) loss offset is possible if a taxpayer opts for establishment abroad through a branch or agency whereas this opportunity is disabled in the event of a subsidiary.

The case was referred to the ECJ for a preliminary ruling by the High Court, before which the case was brought following an appeal against the Special Commissioners’ decision. The latter had rejected the claim for cross-border loss relief set forth by M&S.

The Special Commissioners Decision


[115] Marks&Spencer plc v David Halsey (HM Inspector of Taxes) (SpC 352) [2003] STC (SCD) 70 (hereinafter M&S (SpC)).
The Special Commissioners rejected comparability of situation between losses arising from activities chargeable to tax in the UK and losses which pertain to commercial acts falling outside the UK tax jurisdiction. Therefore, losses of foreign subsidiaries, normally being part of the second category, could legitimately be deprived of the benefit of equal treatment (TEC arts 43 & 48).

Further, non-comparability was found as regards the difference in tax treatment, by the origin state, of two types of secondary investment. That is, treatment differs depending on the structure for establishment: branch or subsidiary. The Commissioners understand the comparison to be drawn between a domestic and a cross-border situation rather than between the two choices of legal form for establishment:

...neither rule should have the effect of treating nationals of the state of origin less favourably when establishing abroad through a branch or subsidiary than is the case for the comparable domestic situation in which the freedom is not exercised.

Despite leading to the same outcome, this is a different approach from that taken by the Advocate General in connection with this comparison.

The Opinion of the Advocate General

The Advocate General examined both grounds which the taxpayer put forward, for the purpose of proving that the UK system of group relief infringes the EC Treaty. The first comparison, which led to a finding of breach, was between the tax position of a UK company with local subsidiaries and one with subsidiaries in another

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116 M&S (SpC) para 99.
117 This is to the exception that CFC legislation applies.
118 M&S (SpC) para 60.
Member State. The UK group taxation system allows transfers of losses among UK-resident companies of a group. This is an advantage which, however, is not allowed in connection with losses incurred by group subsidiaries resident in other Member States. The Advocate General found that the outcome of this disadvantageous treatment qualifies as an ‘exit restriction’. It namely ‘creates an obstacle such as to dissuade companies established in the United Kingdom from establishing subsidiaries in other Member States’.  

Contrary to the Court’s judgment, the Opinion of the Advocate General also examined the second defence ground. The matter involved whether the choice of legal form for investment can be of relevance in surrendering losses to the primary establishment. Thus, the claimants challenged the fact that the parent company was treated differently, depending on the legal form of its secondary establishment (i.e. subsidiary or PE). The Advocate General considered the features of the UK system of group relief as well as cases of PEs’ discriminatory treatment in the state of source. In M&S, however, that case law could only establish comparability of situation on specific conditions. For instance, UK law contains specific provision which grants to UK-located PEs of foreign companies an equal treatment to UK-resident subsidiaries. When it comes to UK group relief, equal treatment between foreign-located PEs and subsidiaries appears out of the question. Thus, PEs’ income is consolidated with that of the Head Office whereas subsidiaries under group relief retain their independence. Consequently, the tax regimes which the UK, as an origin state, applied to subsidiaries and PEs were clearly distinguishable. This difference of legal situation rendered the facts incomparable, which did not allow the Advocate General to take his thoughts any further in this field. The result has been that the UK could maintain a differential treatment between subsidiaries and PEs of UK companies resident/located in another Member State.

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119 M&S (A.G.’s Opinion) para 52.
120 ibid (A.G.’s Opinion) para 53.
121 That is the Avoir Fiscal line of cases.
It should also be noted that, pursuant to the OECD Report on the Attribution of Profits to PEs, issued in December 2006\textsuperscript{123}, the fiscal treatment of PEs shall be closer to that of independent companies. Under such circumstances, the distinction between the two types of secondary establishment does not appear self-evident. In any case, however, this is a matter of limited significance. Thus, regardless of comparability and findings of restriction, a Treaty breach is unlikely to be established. This is because the set of three grounds for justification accepted by the ECJ, as part of the first ground for defence, would also be applicable here.

\textit{The Judgment of the Court}

The ECJ broadly followed the Opinion of the Advocate General and made a finding of restriction. This consisted of depriving parent companies with loss-making subsidiaries, resident in another Member State, of the cash advantage of group relief.\textsuperscript{124} Yet, that facility was available to groups in connection with losses incurred by domestic subsidiaries. It was held that the restriction was ‘of such a kind as to hinder the exercise by that parent company of its freedom of establishment’.\textsuperscript{125}

The Court then followed the pattern established in Gebhard.\textsuperscript{126} The aim of the process was to explore whether there are justificatory grounds which render the restriction permissible. Allowable justifications were then placed under the scrutiny of a proportionality test.

The ECJ acknowledged territoriality as a valid principle of international taxation and Community Law. It clarified, however, that this could not justify a limitation of group relief to losses incurred by resident companies.\textsuperscript{127}

\textsuperscript{123} OECD (ed), \textit{Report on the Attribution of Profits to Permanent Establishments} (Centre for Tax Policy and Administration, Paris 2006) 26 et seq.
\textsuperscript{124} M&S para 32.
\textsuperscript{125} ibid para 33.
\textsuperscript{126} O'Shea (2006) 76.
\textsuperscript{127} M&S para 40.
The Court considered the following three grounds for justifying the restriction:

(i) There must be protection of the ‘balanced allocation of the power to impose taxes’ between the different Member States concerned. Thus, profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system;

(ii) The losses may be taken into account twice (i.e. double-dip);

(iii) There is a tax avoidance risk, mainly the result of loss trafficking.

The justifications under (ii) and (iii) above incorporate straightforward concepts. It was, though, the first time that the ‘balanced allocation of the power to impose taxes’ was brought before the ECJ as an argument for justification. Ever since, the same ground has reappeared in *Rewe Zentralfinanz*, another case of losses, as well as in the Opinion of the Advocate General in pending case *Oy AA*. By contrast, coherence is mentioned nowhere in the judgment of *M&S*, despite the fact that the Advocate General primarily based his Opinion on that ground.

It should be noted that the precise meaning of a ‘balanced allocation of taxing power’ remains vague. The literature which followed the judgment set forth diverging views. Those ranged from drawing no difference between the concepts of ‘balanced allocation’ and ‘coherence’\(^\text{128}\) to speculations on the system’s symmetry.\(^\text{129}\) Discussion on this will follow.

The Court went through each of the justificatory arguments separately and reached the following conclusion:


...restrictive provisions such as those at issue in the main proceedings pursue legitimate objectives which are compatible with the Treaty and constitute overriding reasons in the public interest.\textsuperscript{130}

There was a novelty in this. Thus, for the first time, the ECJ considered the three proposed justifications jointly.\textsuperscript{131} This practice was later confirmed in Rewe Zentralfinanz, which elaborated further on the concept of Member States’ ‘balanced allocation of power to impose taxes’. It was stressed that this justification was accepted in M&S ‘only in conjunction with two other grounds, based on the taking into account of tax losses twice and on tax avoidance’.\textsuperscript{132}

Having established that there are valid grounds for justification, the ECJ proceeded with the test of proportionality. That is the final stage in the process of establishing Treaty infringement. The claimants, together with the Commission, set forth two arguments\textsuperscript{133} in an effort to convince the Court that the UK rules were disproportionate. It was thus suggested that any of the following - less restrictive - rules could instead apply, for the purpose of tackling the risks of intra-EC loss relief. More specifically:

(i) The foreign subsidiary should have taken full advantage of the possibilities available in its Member State of residence to have the losses taken into account; or
(ii) A loss recapture takes place once the non-resident loss-surrendering subsidiary becomes profitable; the amount should be incorporated into the taxable profits of the company which set off the losses.

The Court did not take up the point on loss recapture. It instead agreed that, in specific circumstances under point (i), the disallowance of loss relief is a measure disproportionate to the objectives pursued. Therefore, according to the ruling in

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{130} M&S para 51.
\item \textsuperscript{131} Ibid.
\item \textsuperscript{132} Rewe Zentralfinanz para 41 & the A.G.’s Opinion para 32.
\item \textsuperscript{133} M&S para 54.
\end{itemize}
\end{footnotesize}
M&S\textsuperscript{134}, a parent company shall be liable to consider losses incurred by group subsidiaries resident in other Member States, provided that:

(i) The possibilities of loss carry-back or consideration of current-year losses in the state of the subsidiary’s residence have been exhausted; and

(ii) Loss carry-forward in the state of the subsidiary’s residence is impossible, even by a third party, in particular where the subsidiary has been sold to that third party.

It follows that, according to the judgment in M&S, refusing cross-border loss relief was, in principle, found to be a legitimate restriction to the Freedom of Establishment. There is only a narrow scope of exception to this. That is, where losses cannot be used in the state of the subsidiary’s residence anymore. Impossibility of use covers both losses’ carry-back and carry-forward as well as tax losses incurred in the current year.

**Commentary**

The ruling in M&S has given rise to speculation in connection with a number of issues relating to the current fiscal status of corporations within the EIM. Some key matters are discussed below.

1. Is ‘allocation’ of taxing jurisdiction subjected to the Freedoms?

Following the ruling in M&S, a question that comes to the fore is to what extent the Gilly-originating rule on ‘allocation’ of taxing power remains valid. As shown, the ECJ, in principle, disallowed cross-border loss relief. However, in a limited number of circumstances, it made consideration of such losses obligatory by the state of the subsidiary’s residence. In broad terms, where the use of losses by the subsidiary is not possible anymore, the parent’s state of residence should allow those to be

\textsuperscript{134} ibid para 55.
considered. This is so, irrespective of the absence of jurisdiction to tax the revenues out of which the losses arose.

Despite its narrow scope of application, the outcome of *M&S* has been to place ‘allocation’ of taxing power under the scrutiny of EC Law. This is ground-breaking, in the sense that the ‘allocation’ of tax jurisdiction has so far been understood to fall within the exclusive competence of the Member States.\(^{135}\) It is true that this Gillly-established rule was long expected not to survive the challenges placed by cases with more elaborate facts. Thus, the distinction between ‘exercise’ and ‘allocation’ became increasingly more difficult to identify.\(^{136}\)

In light of the narrow construction of the rule in *M&S*, Gillly still appears to set the principle. Yet, it is also a fact that this rule has now been subjected to exceptions. *M&S* is one exception and the rulings in outbound dividend distributions\(^ {137}\) probably create a second. Further, this override, albeit limited in scope, highlights an effort to bring thinking on equal treatment at the level of the Community. That is, the symmetry of the system should be perceived within a cross-border (EC) framework.

### 2. ‘Coherence’ and the “Balanced Allocation of Taxing Power”

Both the above concepts constitute justification grounds which are commonly used in direct tax cases. Of all justificatory arguments, the above are probably the most debated ones. Coherence, despite having been tackled in *Bachmann*, a case decided as early as 1992, seems to incorporate a notion under constant evolution.\(^ {138}\) The ‘balanced allocation of taxing power’ is a recent term. It was first used in *M&S* and,

\(^{135}\) *Gilly* para 30.

\(^{136}\) ‘...although direct taxation falls within their competence, Member States must none the less exercise that competence consistently with Community law...’. There is no point in listing the specific cases which quote this statement, as it appears in, more or less, the majority of direct tax judgments issued by the ECJ.

\(^{137}\) *ACT IV GLO: Denkavit France*.

\(^{138}\) esp, see *Manninen* and Case C-150/04 *Commission of the European Communities v Kingdom of Denmark* [2007] ECR I-00000 (hereinafter *Commission v Denmark*).
ever since, reappeared in *Oy AA* and *Rewe Zentralfinanz*. Efforts have been made in the post-M&S tax literature to clarify the nature of the concept and place it within the tests of equal treatment. What is more, it has been argued that there is an interrelation between the above two grounds for justification. The analysis that follows is an attempt to shed light onto the matters raised above. Any special significance for corporate cases will also be identified as such.

**Coherence**

The concept involves a direct link between a tax rule which creates a disadvantage in breach of EC Law and a compensatory advantage. Following *Bachmann*, the only direct tax case upheld by the Court on coherence grounds, the ECJ elaborated on the concept in a number of cases. This resulted in a much stricter definition. More specifically, the Court ruled that both the infringing provision and the compensatory advantage should involve the same taxpayer and the same tax. That rendered the chances of success of a coherence defence minimal. Within such a framework, especially cases which accommodated economic double taxation did not have a chance of meeting the requirements of the coherence tests. Economic double taxation, by definition, involves a scheme of two taxpayers.

*Manninen* brought forth a significant change. The test was relaxed to allow that the disadvantage and compensatory advantage do not occur in the same person. This

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141 Bachmann paras 23-27.
144 Manninen paras 40 et seq.
new version of the test is also present in the Advocate Generals’ Opinions in M&S and Oy AA as well as in the judgment in Rewe Zentralfinanz.\textsuperscript{145}

In light of these new developments, cases of economic double taxation, such as Verkooijen, could possibly be reconsidered. The aim should be to identify to what extent the Manninen approach to coherence could have led to a different ruling today. To sustain arguments on coherence, the crucial feature is to establish the so-called ‘direct link’ between a discriminatory/restrictive tax provision and a compensatory rule. In Verkooijen, relief from corporation tax, levied at the distributing company level, was given through an exemption at the level of the dividends’ recipient. Considering this, a valid justification based on coherence, within an EC context, would require knowledge of the payer’s fiscal situation. For instance, exemption may be refused in the origin state if no or low (below a certain minimum) corporation tax is payable by the distributing company.

However, the facts in Verkooijen show that the direct link would be difficult to establish due to the nature of the relief rules. Namely, the exemption amount allowable to the dividend recipient was a fixed one,\textsuperscript{146} which implies that it was not determined in proportion to the corporation tax due at source. In Manninen, by contrast, where the amount of tax credit was fixed as a ratio of the amount of dividends received annually,\textsuperscript{147} the direct link could be easier to sustain.

In M&S, coherence did not appear in the judgment. Yet, it was extensively discussed in the Opinion delivered by the Advocate General. The Manninen rule was, in principle, followed. Analogy to Manninen did not only involve the presence of a second person in the coherence tests. It was also significant for initiating the practice of examining the fiscal situation across border to explore treatment in the other

\textsuperscript{145} M&S (A.G.’s Opinion) paras 71-77; Oy AA (A.G.’s Opinion) para 34; Rewe Zentralfinanz paras 60-61.
\textsuperscript{146} Verkooijen para 10.
\textsuperscript{147} Manninen para 8.
Member State involved. The Advocate General used the term ‘equal treatment’, which gave rise to criticism by the literature, as the content of the concept was regarded as vague. This is possibly a reason why the Court did not retain the Advocate General’s analysis on coherence in the judgment. Still though, it is of interest to look at this construction.

Within the frame of coherence, ‘equal treatment’ refers to an advantageous tax rule in the host state (i.e. state of the loss-making subsidiary). In M&S, that should allow the subsidiary to make use of its losses there and as a result, the state of the parent company may retain its discriminatory/restrictive regime. Thinking of the economic rationale behind ‘equal treatment’, it all seems to be directed towards achieving neutrality of tax treatment in intra-EC transactions. The aim is that business decisions should be distorted to the least extent possible.

All indications given by the Advocate General about ‘equal treatment’ relate to the provision of a loss carry-forward facility in the host state and the possibility to transfer losses to a third party. However, loss carry-forwards incorporate many problematic features which may often reach the point of cancelling the meaning of the term ‘equivalent’. For instance, most states operate some form of loss carry-forward. The availability of an unlimited time span to carry forward would lead to a significant cash-flow disadvantage, since loss relief relies on the idea of an instant benefit.

All the more so, assuming that a loss carry-forward is available in the host state, disparities in tax base and rates place limits to neutrality. In such a context, equivalent treatment may only be perceived by reference to the Freedoms. That complicates the situation, as equivalence of treatment in dealing with the

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148 ibid para 54.
149 M&S (A.G.’s Opinion) para 76.
150 M&S (A.G.’s Opinion) para 82.
subsidiaries’ losses should be determined through the rules of one Member State (i.e. the parent company’s state).\textsuperscript{152}

\textbf{Balanced Allocation of Taxing Powers}

The ECJ in \textit{M&S} did not follow the Opinion of the Advocate General. Instead, it took a new approach to justification which, as explained earlier, involved a joint consideration of three justificatory arguments. Two years after \textit{M&S}, it was confirmed in \textit{Rewe Zentralfinanz} that the ‘balanced allocation of taxing powers’ cannot stand individually.\textsuperscript{153} Instead, it should be considered in conjunction with other grounds for justification.

The meaning of a ‘balanced allocation of taxing powers’ is not entirely clear. Part of the literature\textsuperscript{154} actually draws a correlation between this concept and coherence, implying that both terms have a common point of reference. In connection with \textit{M&S}, it has also been suggested that coherence was in the mind of the Court when discussing the ‘balanced allocation’.\textsuperscript{155}

Quotes from \textit{M&S} and \textit{Rewe Zentralfinanz} delineate the concept in a way which brings it close to ‘allocation’ as established in \textit{Gilly} long ago. More specifically, the judgment in \textit{M&S} reads:

\begin{quote}
...in tax matters profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system in order to protect a balanced allocation of the power to impose taxes between the different Member States concerned.\textsuperscript{156}

...the preservation of the allocation of the power to impose taxes between Member States might make it necessary to
\end{quote}

\textsuperscript{152}\textit{Lang} (2005) 98.
\textsuperscript{153}\textit{Rewe Zentralfinanz} para 41.
\textsuperscript{154}Isenbaert 13.
\textsuperscript{156}\textit{M&S} para 43.
apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses.\(^\text{157}\)

Further, the scope of the concept is delineated in *Rewe Zentralfinanz*:

\[\ldots\text{an argument based on the balanced allocation of the power to impose taxes between the Member States cannot in itself justify a Member State systematically refusing to grant a tax advantage to a resident parent company, on the ground that that company has developed a cross-border economic activity which does not have the immediate result of generating tax revenues for that State.}\(^\text{158}\)

The situation is not, though, as straightforward. Thus, if the ‘balanced allocation of taxing power’ merely replicated the rule in *Gilly*, the scheme would fall outside the scope of the Freedoms. Therefore, there would be no requirement to initiate a test on equal treatment. That is because the higher tax burden borne by the claimant would be a result of the disparities (absence of harmonisation) in the Member States’ tax systems. Yet, the ‘balanced allocation’ has been used as a ground to justify, in conjunction with other arguments, an already established restriction. The difference is significant. Namely, the ‘balanced allocation’, as a justificatory ground, is subject to the Freedoms and becomes part of the tests of equal treatment.

It is obvious that, where ‘allocation’ of taxing power features as a ground for justification, the legal matter does not concern disparities among Member States. In cases such as *M&S*, there is a finding of EC Treaty infringement in the form of discrimination or restriction, being the outcome of exercise of such allocated power. The balance of allocated power seems to be threatened where the system of intra-EC activity suffers some asymmetry.\(^\text{159}\) That should normally take the shape of unrelieved losses, unrelieved withholding taxes charged on dividend distributions, and so on. Asymmetry is the result of taxing the same revenues twice or not at all.

\(^{157}\) ibid para 45.

\(^{158}\) *Rewe Zentralfinanz* para 43.

\(^{159}\) Farmer (2007) 44.
Equally, losses and other deductible amounts may also be considered twice or not at all.

In the context of the state-by-state tests for compliance with the Freedoms, it is often necessary to examine the tax regime across the border; that is, in another Member State. The aim is to ensure that tax is imposed once and relief is also made available once in any of the two Member States. Consideration is at Community level. What is more, fiscal costs are not an issue, as neutrality under the EC Treaty does not guarantee an equal tax burden. Where symmetry is absent, the scheme is in breach of the Freedoms and the only way to rectify this situation is through intervening in the Member States’ tax bases. Namely, in that particular instance, one of the two bases will broaden whereas the other will equally decrease.

**Commentary**

In a framework of facts similar to *M&S*, both concepts (i.e. ‘coherence’ and ‘balanced allocation’) have the objective of making losses deductible once. This is what symmetry requires; otherwise, the outcome may be either a double-dip or the losses remain unrelieved. Neutrality of legal treatment drives the thinking behind most of the ECJ’s judgements in the field of the EIM. It concerns the creation of such conditions within the internal market that carrying on commercial activity is not discouraged if compared to similar domestic transactions. In this respect, it could perhaps be noted that a loss recapture system could possibly serve the objective of neutrality/symmetry. It would, namely, allow cross-border transfers of losses and then guarantee neutrality through the recapture. Yet, loss recapture was not referred to in the judgment.

It is apparent that a group taxation scheme of consolidation provides for the opportunity to set off intra-group losses against profits. Further, since this is meant to be a structure functioning separately from national tax systems, it should feature
no risk of double-dip or of leaving the losses unrelieved. Special provisions should however be made for loss recapture. Since losses are considered at the level of the consolidated group tax base, arrangements should be made if those are recaptured once a loss-making group entity becomes profitable.

III. The Treatment of Permanent Establishments by the Host State

One of the key issues in the taxation of MNEs within the EIM is the tax treatment accorded to PEs in the state of their location.\(^{160}\) Within a group taxation scheme of EC-wide scope, consolidation and apportionment place PEs and Head Offices on an equal footing. Further, instances of discrimination/restriction are not likely to occur internally as common rules are applicable across the group. PEs become significant where their Head Offices are resident outside the territorial contours of the group. However, those sets of facts exclusively involve entities resident in third countries and this takes them out of the ambit of the EC.

The starting line in this field is Avoir Fiscal. The ECJ required that branches of companies resident in another Member State should be accorded equal treatment to resident subsidiaries. The main argument has been that tax charges were imposed to the above two forms of secondary establishment without distinction. Similar rulings were given in the line of cases which followed the path of Avoir Fiscal: Commerzbank\(^{161}\), RBS\(^{162}\) and Saint Gobain. Considering that the same tax rules were

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\(^{160}\) For a detailed examination of the implications associated with awarding residence or simply granting entitlement to the DTC benefits, see: HE Kostense, "The Saint-Gobain case and the application of tax treaties: Evolution or revolution?" (2000) 9 EC Tax Review 220 et seq.

\(^{161}\) Case C-330/91 R v IRC, ex parte Commerzbank AG [1993] ECR 1-4017 (hereinafter Commerzbank).

\(^{162}\) Case C-311/97 Royal Bank of Scotland plc v Elliniko Dinosio (Greek State) [1999] ECR 1-2651 (hereinafter RBS).
applicable, comparability of situation was found to exist between domestic companies and EC-resident foreign companies with local PEs.

*Saint Gobain* is a step further in the *Avoir Fiscal* line of cases.\(^{163}\) It brought the application of 'national treatment' in the host state up to the level of DTC entitlement. The case examines the situation from the perspective of the host state (i.e. the state of the PE's location). It raises the issue of a PE's equal treatment at the level of DTCs. More specifically, the question is whether EC Law requires that a PE should be entitled to the benefits of DTCs concluded by the state of its location. Drawing from *Avoir Fiscal*, it should be a prerequisite for the above that a PE's tax base is computed pursuant to the same rules as those applicable to resident companies. The question of DTC entitlement arose from the fact that DTCs, in their status as international agreements, are part of the legal order of the state of the PE's location. Therefore, it would be inconsistent with 'national treatment' to deprive PEs of the advantages arising from the law of that state.

This cannot, however, lead to a straightforward conclusion.

One concern was whether a PE's entitlement to DTC benefits should be coupled with tax residence in the host state. On this point, the ECJ did not go any further than concluding that PEs of non-resident companies should be granted DTC advantages *'on the same conditions as those which apply to resident companies'*.\(^{164}\) It follows that the Court did not determine which DTC should be applied in the given triangular context. Nor did it enter into a discussion about how the treaty benefits would be conferred on a non-resident (i.e. the PE).

A second issue involved whether the benefit entitlement presupposes that the PE is subject to worldwide taxation in the host state. In *Saint Gobain*, the PE was taxable

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\(^{164}\) *Saint Gobain* para 58.
in Germany on foreign dividend income attributed to it, which was understood to equal an unlimited tax liability.

Both the above questions have as yet not been given a definite answer.

A third complexity related to the legitimacy of extending DTCs to third parties (i.e. non-signatory parties). Under public international law, 'treaties may neither impose obligations on, nor create rights for, third states, except if the third party gives its consent to the above. The consent, where it concerns entitlement to rights, may be presumed, unless the Treaty in question provides otherwise. Considering that a PE's entitlement to the host state's Treaty benefits makes sense because that DTC is more beneficial, a case of presumed assent could potentially be arguable.

Saint Gobain starts off from a simple affirmation. That is, to the extent that PEs and resident companies are subject to the same fiscal rules, they should also be entitled to the same benefits. Thus, this would create a neutral setting as regards the choice of legal form for (secondary) establishment. It is, however, doubtful whether EC Law places any such requirement. On the other hand, awarding a PE with residence status appears a distant prospect and this is, by no means, a necessity in achieving EC Law compatibility.

It follows from the above that Saint Gobain does not provide a definitive solution to the issue of PE entitlement to DTCs. This is partly due to the peculiarities attached

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165 see also: Offermans and Romano 184 & 187; in the author’s opinion, Saint Gobain is not a case dealing with MFN, which was anyway rejected in 'D'. This case may have involved an extension of a DTC to a third party. However, the set of facts in Saint Gobain does not fit the conditions for applying MFN. Thus, MFN is about allowing entitlement to the most favourable provisions conceded by the taxing state, in a specific issue, through its DTCs. In Saint Gobain, the aim was not to give the PE the most favourable tax treatment available under DTCs concluded by Germany in connection with receipts of foreign dividends. The claim primarily required equivalent treatment to that of German-resident companies. MFN within the EC was, in any case, rejected in 'D'. However, the Court in 'D' also turned down the proposition of similarity to Saint Gobain. It was explicitly pointed out that the two cases involved a different comparison.

to the facts of the case, which do not allow conclusions to be drawn. Progress in the area should therefore be expected through future litigation.

IV. Intra-Group Asset Transfers

Asset transfers among associated companies can be distinguished into two groups: (i) those falling within the scope of the EC Merger Directive\textsuperscript{167}; they qualify for a deferral of tax on the gain accruing to the transferor; and (ii) those considered by the Court for compliance with EC Law on the basis of the fundamental freedoms. The first category (i.e. \textit{Leur-Bloem}\textsuperscript{168}, \textit{Sevic Systems}\textsuperscript{169}), linked to the interpretation and application of the EC Merger Directive, is examined as part of Chapter 2 on positive integration.

The leading authority in the second category (where the EC Merger Directive is excluded) is \textit{X and Y}. This is a case on group taxation. The ECJ found a Swedish rule which excluded from tax deferral transfers of shares at undervalue to be in breach of the Freedom of Establishment. The transfers were made by a Swedish legal person to an associated Swedish limited company, while the latter was held by a foreign parent. This was a case of illegal restriction in which the transferor was deprived of a cash advantage because the parent of the transferee was situated in another Member State.\textsuperscript{170} The restriction consisted of a limitation to the right to invest in foreign-held companies. Arguments of tax evasion were put forward to justify the non-deferral. These mainly focused on the association among the group


\textsuperscript{168} Case C-28/95 \textit{Leur-Bloem v Inspecteur der Belastingdienst/Ondernemingen Amsterdam} 2 [1997] ECR 1-04161 (hereinafter \textit{Leur-Bloem}).

\textsuperscript{169} Case C-411/03 \textit{Sevic Systems Aktiengesellschaft v Amtsgericht Neuwied} [2005] ECR I-10805 (hereinafter \textit{Sevic Systems}).
entities which were parties to the transaction. However, the ECJ, in line with its settled jurisprudence, interpreted anti-abuse provisions strictly. It was held that ‘tax evasion or tax fraud cannot be inferred generally...’\textsuperscript{171} and that the provision in issue was ‘not specifically designed to exclude from a tax advantage purely artificial arrangements’.\textsuperscript{172}

\textit{DeBaek}\textsuperscript{173}, which followed, was not a corporate case: Here, the transferor was an individual. The facts generated legal issues in the nature of X and Y\textsuperscript{174}, since an association between the transferor and the transferee was, again, of relevance. Compared to X and Y, \textit{DeBaek} dealt with a much more straightforward restriction: the transfer of shares to a foreign company led to a charge to capital gains tax whereas a similar transfer to domestic companies did not.

It follows that, where the EC Merger Directive is not of application, intra-group asset transfers are treated by the ECJ under equal terms to those of all other cases decided on the basis of the Freedoms. Further, the arguments for justification do not present features peculiar to asset transfers. Rather, they abide by the mainstream rule of non-discrimination/non-restriction tests discussed under Part A of this chapter. Intra-group asset transfers are eliminated when they take place within a group taxation scheme of consolidated base. It follows that equal treatment is unlikely to be breached in this context. However, discrimination/restriction should become relevant where a group terminates or an asset leaves the group, which implies that capital gains may need to be recaptured.

\textsuperscript{170} X and Y para 38.
\textsuperscript{171} ibid para 62.
\textsuperscript{172} ibid para 61.
\textsuperscript{173} Case C-268/03 \textit{Claude De Baecck v Belgische Staat} [2004] ECR I-05961 (hereinafter DeBaek).
Conclusion

In devising an EC-wide group taxation system, the jurisprudence of the ECJ is a field of necessary background knowledge. It thus protects the legislator from making choices which may later be struck down by the Court as illegitimate. The non-discrimination/non-restriction tests feature a structure based, in many cases, on a comparison between domestic and equivalent cross-border facts. This ‘bilateral’ thinking is structured on a premise which is fundamentally different from the rationale behind comprehensive approaches. Considering this, the case law of the ECJ is meant to act more as a safeguard rather than as a source of inspiration in connection with positive integration initiatives.

In addition, the jurisprudence often acts as guidance to the legislator. It identifies specific national features which infringe the Treaty. Those may then be tackled at EC-level through projects in the field of positive integration. Keeping track of developments in the case law is therefore essential to a thorough understanding of legislative initiatives. For instance, in the aftermath of M&S, there seems to be some action in the area of cross-border losses. The same applies to exit taxes following de Lasteyrie and N.

The ECJ’s jurisprudence intervenes to rectify a Treaty infringement. On the other hand, an EC-wide group taxation system reaches for the broader objectives which permeate the EC Treaty as a whole. The latter are in principle non-enforceable but contribute decisively to the process of market integration. A discussion of those objectives will follow in chapter 4 of this thesis.

174 ibid para 24.
2. **Positive Integration Relevant to Groups**

**Introduction**

Through the lens of the objectives central to the EIM, this chapter examines the legislative activity of the European Community in the field of corporate taxation. The focus will be on corporate groups. In any case, the vast majority of corporate tax issues at European level involve arrangements between associated companies and, therefore, have a direct impact on groups. The analysis will cover both legislative initiatives which never came into fruition as well as the law currently in force and plans for future development.

Most positive integration initiatives have so far been received with suspicion, if not hostility, by the Member States, which explains the poor record of legislative acts. The current institutional structure of the EIM in taxation involves a low degree of integration if compared to state entities of a federal structure. Thus, in the area of direct taxes, in particular, strong intergovernmental features dominate the applicable regime. The competence to legislate direct taxes primarily rests with the Member States. The EC Treaty does not explicitly confer any power on the Community in relation to direct taxation. Neither does it set any harmonisation objectives in this field. All legislative action so far taken has found legal ground in TEC art 94. The rule provides, on the prerequisite of unanimity, for laying down rules aiming at the approximation of laws, affecting the establishment or functioning of the common market.
Part A: Unsuccessful Integration Efforts up to the early 1990s

The idea of harmonising corporate taxation across the EIM is not a development of the 1990s or the early 21st century. Instead, it appears as early as in the policy documents of the 1960s. In the Segré Committee Report179, published in 1966, it is expressly mentioned that the fiscal systems in Europe should not obstruct the creation of conditions similar to those of an internal market. The report further stressed the importance of location neutrality and of neutrality in the form of secondary investment.180 Additionally, some of the most cutting-edge issues, currently under discussion, had been identified by the Segré Committee as areas for action. Just by indication, the Report included proposals for the replacement of existing bilateral DTCs by a multilateral treaty concluded among the Member States. Issues such as the extension of tax credits to non-resident shareholders, later found to be in breach of the EC Treaty181, were also within the areas of recommended action. Surprisingly enough, the approximation of corporate tax bases also featured as an item for urgent action in the Commission programme for harmonisation of direct taxes.182 This was published in the aftermath of the work of the Segré Committee.

Building on the development of the 1960s, the following years saw legislative initiatives in the form of Commission Reports and Proposals for Council Directives.

181 By indication, the key ECJ judgements in this area are: Boars, Verkootjen, Lenz, Manninen.
182 Easson at 605.
Some dealt specifically with corporate taxes in the EIM but all failed to reach fruition until the early 1990s. As taxation has always lain at the heart of state sovereignty, harmonisation of direct taxes proved to be a project too premature to materialise in the 1970s and 1980s. Even where proposals only took the shape of specifically targeted measures, such as the Parent-Subsidiary and EC Merger Directives, significant delays occurred. The above Directives were only adopted in 1990 following their initial proposal in 1969. Some of the unsuccessfully proposed measures are worth mentioning, as they are relevant to group taxation. They could possibly prove useful in assessing currently pending initiatives in the same field.

One key topic of debate is whether the approximation of corporate tax rates should be among the EIM objectives. The position taken in the Commission Proposal 1975 has been in favour of approximation in a range between 45 and 55 percent. The same policy choice has been confirmed in the subsequent documents up to the Ruding Report in 1992, which incorporated a suggestion for a bandwidth of 30 to 40 percent. Ever since, corporate tax harmonisation initiatives have focused on the prospect of a harmonised tax base coupled with a system of profit allocation to eligible Member States. The system allows national tax rates to continue applying.

In a short note published in early 2005, Onno Ruding took a stance in favour of tax rate approximation. He insisted on that necessity, for the purpose of tackling

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185 The Ruding Report.


cases of distortion and discrimination within the EIM. His proposal is for a rate span between 20 and 30 percent (or 35 percent) which, to his understanding, can also retain a level of competition among Member States. It is true that tax rate diversity may contribute to enhancing tax competition within the EIM but is also associated with disadvantages. It risks defeating the objective of inter-jurisdictional equity, as it distorts the choice of place of investment. It should be noted that the effect is expected to be a lot more intense in a context of source-base taxation, which is often the applicable system within integrated markets.

Another issue which the Commission sought to settle as early as 1975 concerned the extension to all shareholders of relief available against tax liability in the state of residence. The proposed provisions gave entitlement to a partial imputation credit, which was to be granted at the expense of the state of source. More specifically, the dividend recipient would be entitled to deduct the credit amount from its final tax liability at the state of residence. The imputation credit would be computed as a percentage of the corporation tax paid at source. That would be determined by the state of residence within a range of 45 to 55 percent. The sum of the imputation credit was then to be recuperated from the state of source, which was to bear the respective cost. Consequently, the credit cost obliterated the advantage of the withholding tax (levied by the state of source upon distribution). The purpose of this compensatory payment was to alleviate the erosion of the tax share of the state of residence. Such a scheme clearly departs from the principles of inter-jurisdictional equity which promote source-base taxation within markets of a high degree of integration. What is more, the mechanism involved a great deal of administrative impracticality. The Ruding Report, in dealing with distributions, stayed firm to the

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188 Easson 607.
190 ibid 10-11 & 20.
imputation credit but seems to have abandoned this compensatory aspect of the Commission Proposal 1975.

The Commission Proposal 1975, which took steps to tackle the issues set out above for the first time, was badly received by the Parliament and was finally withdrawn in 1990.

An effort to lay down a system of cross-border loss relief in the context of groups of companies was made by virtue of the Proposed Losses Directive in 1990. Despite the support given to this Proposal by the Ruding Report two years later, the attempt to reach agreement by the Member States was unsuccessful. That led the Commission to withdraw it for further consideration in 1999. The Proposed Losses Directive put forward a solution of cash flow advantage, as it provided for a loss recapture mechanism. The scheme involved a recapture of losses once the subsidiary became profitable or, at the latest, by the end of the fifth year following consideration of a loss amount.\(^\text{192}\) It is further clarified that the taxable income of each subsidiary shall be computed in accordance with the rules of the Member State of its tax residence.\(^\text{193}\) Finally, the law makes specific reference to states that maintain an alternative loss relief method, such as consolidation, and allows them to retain it.\(^\text{194}\)

The proposed system, designed as a cash flow advantage, aims at preventing the same losses from being surrendered more than once ('double-dip'). This is an objective which may be circumvented, unless appropriate domestic anti-abuse rules are put in place. Potential problems lie in the interaction between the Directive rules and existing domestic systems of group relief. For instance, a risk could surface if domestic law, such as the UK system, allowed horizontal loss relief (i.e. losses of a subsidiary to be set off against the profits of a sister subsidiary). In such an event,

\(^{192}\) Proposed Losses Directive arts 9 & 10.
\(^{193}\) ibid art 9(2).
\(^{194}\) ibid art 12.
the provisions of the Directive did not preclude that the loss be surrendered twice.\textsuperscript{195} If this Proposal had come into fruition, it could probably have prevented cases, and notably M\&S, from reaching the Court.

The Proposed Losses Directive specifically targeted at solving loss relief problems within groups rather than addressing a wider spectrum of issues. A comprehensive scheme would instead extend to areas such as transfer pricing, thin capitalisation, tax deferrals in cross-border intra-group transfers.\textsuperscript{196} The recuperation of losses also witnessed a system which essentially abided by the surviving inter-governmental character of the EIM. Each sovereign state strived for the integrity of its tax base. By contrast, a supra-national approach would possibly deprive the surrendering subsidiary from using the losses in the future rather than arrange a recapture.

The issue of intra-EC losses' tax treatment was reconsidered by the Commission in a Communication of December 2006.\textsuperscript{197} Three alternatives for loss relief in cross-border situations were proposed:

(i) A \textit{Definitive Loss Transfer} ("intra-group loss transfer") which involves a permanent transfer of losses (or profits). There is no recapture when the surrendering company makes a profit. It is also mentioned that some clearing system may need to be devised, for the purpose of compensating the loss-absorbing Member State;

(ii) \textit{Temporary Loss Transfer} ("deduction/reintegration method"); this is a method providing a cash-flow advantage. The loss is recaptured by the surrendering company once it becomes profitable.

(iii) \textit{Current Taxation of Subsidiary's results} ("system of consolidated profits"); this is system of bringing together, at the level of the parent company, all profits and losses of a group's members. A deduction of the tax paid by each of the group subsidiaries in their states of residence should be made available to the parent. Here, loss relief is an immediate outcome of consolidation.

\textsuperscript{195}Easson 625.

\textsuperscript{196} This is an approach taken by the Commission Staff Paper of 2001, which, apart from specifically targeted measures, also puts forward comprehensive solutions.

\textsuperscript{197} COM(2006)824.
Part B: Successful Legislative Initiatives

Positive integration in the field of corporate taxation has been limited in scope and could be divided into two phases: (i) the group of initiatives which materialised in 1990 (i.e. P-S Directive, EC Merger Directive and Arbitration Convention) and (ii) the so-called Tax Package, adopted on 3rd June 2003, part of the content of which (i.e. Interest & Royalties Directive\(^{198}\) and the Code of Conduct) has a strong relevance to MNEs.

A brief overview of positive integration is given below. Analysis is kept short, as this work does not aim at entering into a comprehensive analysis of secondary Community law in the field of tax. Some basic information is set as a background to the core part of the thesis, which looks into the prospect of devising a group taxation scheme for MNEs applicable across the EIM.

(i) Parent-Subsidiary Directive

Provision is made for the abolition of withholding taxes on dividend distributions at source and for the prevention of double taxation through relief (i.e. underlying credit or exemption) at the level of the parent company. The Directive was recently\(^{199}\) amended to extend its ambit to a wider list of companies, which also includes the European Company (SE).\(^{200}\) Part of the amendment has also been to provide for a


gradual reduction down to 10 percent in 2009 of the holding requirement for application of the P-S Directive. Entitlement has also been granted to PEs and to cases of indirect holdings (provided that tax has been paid by at least one of the subsidiaries in the chain).

Some complexity arose in relation to the required minimum holding period. The ECJ ruled on the issue in Denkavit and drew a distinction between: (a) the 2-year holding requirement for the purpose of being granted a definitive entitlement to the privileges of the Directive and (b) the requirement that a full 2-year holding period should have been completed at the time that the respective return for the dividend distribution is filed with the Authorities or the distribution takes place. Namely, the 2-year holding period means that, if the parent company disposes of its holding before the required time span elapses, dividend distributions are taxable. That is, they no longer qualify for the benefit of the P-S Directive. This does not, however, imply that distributions taking place in the meantime cannot seek entitlement to the Directive.

The ECJ has interpreted the concept of ‘withholding tax’ in Athinaiki. The facts concerned a Greek subsidiary company which distributed profit to its Netherlands parent. The relevant amounts had been subjected to corporation tax at source with exhaustion of further liability pursuant to the relevant provisions of Greek income tax. However, the specific category of income where exhaustion occurs through taxation at source is subject to an additional tax burden due upon distribution or capitalisation. This is typically still classified as ‘corporation tax’ under Greek law. The Court, staying firm to its principle of substance over form, rejected the reasoning that the challenged tax liability qualified as corporation tax. Instead, it was convinced that it actually functioned as a withholding tax. This was found to be so,

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201 P-S Directive art 3(2).
despite the fact that the respective amounts were to be borne by the distributing company. An argument featuring in the ruling is that the arising tax liability could not be offset through the use of negative income from previous tax years. With certainty, this was at odds with the principles allowing a loss carry-forward. It was thus understood to highlight the distinction of that particular charge from corporate taxes. Considering that the distribution in issue fell within the scope of the P-S Directive, the arising tax liability was found to be prohibited.

A final remark in connection with the P-S Directive concerns the compatibility of Article 4(2) with the Freedom of Establishment. The provision allows Member States to retain national regimes of non-deductibility of holding charges at the level of the parent company. The ECJ refrained from considering precisely the compatibility issue in Bosal, limiting itself to the statement that the option of Article 4(2) may be ‘exercised only in compliance with the fundamental provisions of the Treaty’.

(ii) EC Merger Directive

The Directive allows the deferral of tax on the gain arising from cross-border corporate restructurings. Those may be carried out in the form of mergers, divisions, transfers of assets in exchange for securities or schemes of ‘exchange of shares’. It is beyond the scope of this work to give details of how each of the above restructuring techniques can be accomplished. It should be clarified, though, that the tax deferral is only a cash advantage meant to last until a later disposal of the assets. In a recent amendment, the ambit of the Directive was extended to cover ‘split-offs’ in exchange for shares in the receiving company.

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204 Athinaiki para 27.
206 Athinaiki para 29.
207 Bosal para 26.
210 This involves transfers of assets that constitute a distinct branch of activity.
Despite having been in force since 1992, the EC Merger Directive has been used by the Member States to a very limited extent – if at all. This is so, because the corporate law framework for implementing the Directive is missing in a number of countries. Headway is expected to occur through the corporate basis for restructurings given by the SE Regulation. Again, however, further coordinated action is required. The SE Regulation only provides for mergers of public limited liability companies of different Member States. An additional condition is that the merger should lead to an SE. In that context, it should be noted that, in Sevic Systems, the Court found the German corporate law on mergers in breach of the Freedom of Establishment. Illegitimacy originated in the unavailability of corporate provisions allowing cross-border mergers.

The scope of the anti-abuse provision of the EC Merger Directive has been interpreted in Leur-Bloem. The Court gave a strict literal interpretation of the anti-abuse clause. It ruled that, if the operation was not carried out for ‘valid commercial reasons’, there is a presumption of tax evasion or avoidance. There is no common view in the literature about whether the presumption is refutable. Indeed, it was also suggested that a general rule automatically excluding certain categories of operations from the scope of the Directive goes further than necessary. It is therefore disproportionate to the objects it pursues and so in breach of EC Law.

(iii) EU Arbitration Convention and Soft Law on Transfer Pricing

Transfer pricing disputes are part of an MNE’s everyday life. They involve excessive compliance obligations and have proved considerably time-consuming. In

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211 See also: A Rainer, ‘ECJ Hear Case on Cross-Border Mergers’ (EC Tax Scene) (2005) 33 Intertax 405.
these circumstances, an EU Arbitration Convention was proposed, for the purpose of acting as a dispute settlement mechanism. The aim was to provide for an EC-wide framework for the elimination of double taxation in transfer pricing disputes. Despite the initial plan to give it the form of a Directive, the instrument was finally enacted as a multilateral international agreement. This takes its interpretation/application out of the jurisdiction of the ECJ. Unlike the Mutual Agreement procedure in the context of DTCs, the EU Arbitration Convention provides for mandatory arbitration if Mutual Agreement is not reached. The application of the Convention, however, encountered difficulties, since there has been uncertainty as regards the precise starting point of the various deadlines being part of the procedure. Practical problems also arose in connection with the suspension of tax collection for as long as the dispute resolution lasts. What is more, serious delays were incurred in bringing into force a Protocol\footnote{Protocol to the EU Arbitration Convention of 25 May 1999 amending the Convention of 23 July 1990 [1990] OJ C202.} granting the Convention automatic extensions of 5-years each. Following an initial 5-year period of application, the Protocol, although signed without delays, was only ratified by the 15 Member States at the end of 2004. It was then given retroactive effect referring back to 1\textsuperscript{st} January 2000.

In June 2002, the European Commission set up a body under the name of the ‘EU Joint Transfer Pricing Forum’ to deal with transfer pricing issues in the EU. The objective has mainly been to tackle transfer pricing matters through soft law instruments. The Forum consists of experts from all national administrations as well as of business representatives. Its work programme was initially set for two years with the principal aim to work towards a Code of Conduct for the implementation of the EU Arbitration Convention. Indeed, the Joint Transfer Pricing Forum is still in operation after its mandate was extended twice by the Commission (i.e. 2004 and 2006).
The work of the Forum is guided by the problems identified and objectives set in the Staff Paper. Overall, the approach taken is to use the OECD Transfer Pricing Guidelines as the starting point for EC initiatives. In light of this, the Forum has mainly worked on three areas since it was first convened in October 2002. As part of its first task, it explored ways of rendering the Arbitration Convention more effective. This led to a Code of Conduct adopted by the Council in December 2004. A second Code of Conduct on transfer pricing documentation for associated companies exists since July 2006. Again, the idea originates in the Staff Paper. The Code targets at reducing compliance complexities relevant to the collection of transfer pricing documentation in intra-EC trading among associated companies. Some rules are thus laid down to standardise documentation that MNEs are liable to submit to the tax authorities of EC Member States.

Finally, the most recent development is a Communication of February 2007 dealing with Advance Pricing Agreements (APAs) at European level. The underlying rationale has been to offer a solution which prevents costly and time-consuming transfer pricing disputes. Priority is therefore given to an ex ante, rather than an ex post, method of tackling double taxation. There is provision for unilateral as well as bilateral and multilateral APA programmes. The proposal is for a centrally

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218 Staff Paper 346.
221 Staff Paper 348.
coordinated scheme. Further, a regulatory framework for negotiation among the competent tax authorities is set out. Detailed reference is also made to the responsibilities of the taxpayer applying for an APA, especially the tasks attached to initiating the procedure.

(iv) Interest and Royalties Directive

This is a recently enacted law which requires that no withholding tax is levied at source upon interest/royalty payments made to companies or PEs of companies of the same group. This is in line with the core objective of elimination of double taxation in the EIM. The holding requirement for application of the Directive is 25 percent. The Directive was amended on 1st May 2004 to allow for transitional regimes in favour of some of the new Member States. Three of the 'old states' (Greece, Portugal and Spain) have also been granted transitional periods. Those regimes may concern both interest and royalties (Greece, Latvia, Lithuania, Poland and Portugal) or be limited to royalty payments (Czech Republic, Slovakia and Spain). The withholding tax rates may go up to 10 percent for an initial period of 4 to 6 years and then, should be reduced to 5 percent for the remaining part of the transitional time. Further, the Member State of the recipient company or PE is under the obligation to give relief for the withholding tax charged under the transitional regime. Finally, a Proposal for amendment of the I & R Directive is currently pending. The objective has been to ensure that the privileges of the Directive are only made available to recipients which bear taxes at residence. Exempt companies/PEs do not qualify for the privilege of the Directive. The Proposal also extends the list of eligible companies to add the SE and the European Cooperative Society (SCE).

223 I & R Directive art 3(b).
Part C: Future Developments

The turn of the century saw a re-emergence of the plan to harmonise corporate taxation at the European level. The process was triggered by the extensive Staff Paper on company taxation, issued by the European Commission in 2001. Ever since, progress in the area is regularly reported in a series of Commission Communications.\textsuperscript{227} A Report stating the position of the European Parliament was also published in 2006.\textsuperscript{228}

The Staff Paper identified the areas in which the lack of harmonisation in direct taxes created obstacles to the functioning of the EIM. It also discussed remedial measures classified in two categories: (i) ‘targeted’ measures and (ii) ‘comprehensive’ measures. The former involves tackling the identified obstacles one-by-one (i.e. cross-border loss relief, cross-border intra-group asset transfers, distribution of dividends, transfer pricing and thin capitalisation). The comprehensive measures propose four fully-fledged group taxation systems. Those may either be alternatives or apply each to a different type of entity (at the same time). They are meant to allow highly integrated businesses to benefit from harmonised direct taxation schemes in the EIM.


The European Commission hosted a series of consultation sessions with interest groups as well as a number of conferences on EC company taxation. The aim has been to consider identified problems and potential remedies. In particular, the discussion largely involved the feasibility of bringing any of the proposed comprehensive solutions to materialisation.

The outcome was a decision to promote two of the proposed models: the Common Consolidated Corporate Tax Base (CCCTB) for MNEs and Home State Taxation (HST) for Small and Medium Enterprises (SMEs).\(^{229}\) In principle, both systems are envisaged to apply on an optional basis and involve a consolidation of the group results. The outcome is then to be coupled with apportionment of the group tax base to the eligible states. In contrast, a centrally administered EU Corporation Income Tax (EUCIT),\(^ {230}\) wholly or partially attributable to the revenues of a Community Authority, appeared a rather unlikely prospect. It was thus found that the amount of harmonisation in direct taxation was still small. As a result, the Member States retained an exclusive right to impose direct taxes.\(^ {231}\) Having been one of the Staff Paper’s proposed alternatives, EUCIT was put aside for future consideration. It was thought to go much further than what could match the stage of market integration in the EC at the time.

Under both the CCCTB and HST, the use of apportionment for determining tax liability in each Member State provides a solution to complexities inherent in transfer pricing. The Staff Paper contains a discussion of the difficulties attached to computing the value of transactions pursuant to arm’s length separate accounting.\(^ {232}\)


\(^{230}\) Staff Paper 377; for more details on EUCIT, see: M Gammie, ‘Corporate Taxation in Europe – Paths to a Solution’ [2001] British Tax Review 233 (hereinafter Gammie (2001)).


\(^{232}\) A detailed analysis of the formula and its advantages as well as of the challenges placed by arm’s length pricing within integrated markets is provided in chapter 9 of this thesis.
Indeed, drawing comparable prices within closely integrated businesses features as one of the key drawbacks of pricing on a transaction basis. This problem can be dealt with through the profit allocation mechanism (i.e. apportionment). What is more, consolidation allows losses incurred by the group companies to be automatically offset and intra-group dividend payments to be disregarded.

In the informal ECOFIN meeting of September 2004, agreement was reached for the creation of a Commission Working Group for the CCCTB. The Group had its first meeting on 23rd November 2004. Its work can be followed through the relevant webpages on the website of the Directorate General for Taxation and the Customs Union. Apart from the documents which specifically report on the agenda and the conclusions of the Working Group, progress has also been reported in the series of Community Communications published since 2004. To conclude, according to the time-schedule, a proposal for a Directive should be expected in 2008.

Questions arise on the tests for group membership: holding percentage and unitary business. In addition, the geographical contours of the group bring forward the concept of 'water's edge'. This is likely to create complexity in the operation of the DTC networks both among the Member States and vis-à-vis third countries. Another area of complexity involves agreeing on a single tax base, especially in the absence of a federal pattern to function as a starting point alongside the US principle. Finally, the factors which determine the allocation of apportioned profit should be defined and weighed in such a way that they do not risk being manipulated by tax avoidance schemes.

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234 See esp. Commission (EC), 'Progress to date and future plans for the CCCTB' (Working Document) CCCTBWP020/doc, 15 November 2005 (hereinafter Progress Report CCCTB Nov 2005); idem 'Progress to date and future plans for the CCCTB' (Working Document) CCCTBWP046/doc, 20 November 2006 (hereinafter Progress Report CCCTB Nov 2006); all documents will be considered in detail, where relevant, in later chapters of this thesis.


236 Hellerstein and McLure 91 et seq.
Devising a group taxation system of consolidation, meant to apply across the EC, highlights, among others, the issues briefly stated above. The core part of this thesis is dedicated to examining the content and applicability of those concepts in light of the EIM principles and objectives.
3. Deriving Examples from Corporate Tax Systems at Sub-Federal Level: Canada, Switzerland and the United States of America

Introduction

The EC is an integrated market in several fields. In direct taxes, though, it is highly fragmented still consisting of twenty seven systems; that is, as many as the Member States. Group taxation schemes, where present in the EC, operate at national level in principle. There has never been a central mechanism for allocating EC-wide revenues to the eligible Member States. It is therefore obvious that experience in group taxation at sub-national level is poor in the EC. Considering this, useful input can be derived through exploring structures of sub-national corporate taxes in certain federal-type markets. This chapter contains surveys of...
the basic features of the tax systems of Canada, Switzerland and the US. It is a general approach, which aims at showing the evolution of key structural elements in sub-federal direct taxation over the centuries. So, the analysis below will not engage in a discussion of specific elements of the systems reviewed. Precise references with a relevance to group taxation will be made in later chapters.240

The choice has been made for the above three countries because, among federal-type states, those are probably the only ones to levy corporation tax at sub-national level. The Canadian system presents features of a high degree of coordination/uniformity and lies the closest to the end occupied by regulation. Switzerland used to be nearby the other end (i.e. ‘tax competition’) before the Tax Harmonisation Law (THL) entered into force.241 It has now adopted a harmonised tax base at cantonal level, which has brought the system closer to regulation. Finally, most elements of the US system are favourable to tax competition.

Part A: Canada

I. An Overview

The Canadian constitutional framework242 in fiscal matters is an interesting blend of decentralised structures coupled with uniform rules applying across the country.

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240 That is, namely, Chapter 6 on the entitlement to group membership, Chapter 7 on the group tax base, Chapter 8 on the territorial scope of the group and Chapter 9 on the Formulary Apportionment.
Corporation taxes are part of this system and, since the Confederation was created (1867), they have been shaped to fit the various historical developments. The discussion below on Canadian fiscal federalism will primarily shed light on the evolution of corporate taxation.

The federal government and the provinces hold concurrent jurisdiction to levy direct taxes. The fact that the provinces enjoy a taxing entitlement is a feature of decentralisation which highlights the federal identity of the system. This aspect is further reinforced by the provinces' freedom to determine corporate tax rates independently of the federal government. On the other hand, agreement has been reached on a uniform tax base and profit allocation mechanism. For the provinces, the adoption of the above uniform rules is part of the deal of entering into Tax Collection Agreements (TCAs) with the federal government. Namely, that is an obligation which they undertake in exchange for the tasks borne by the federal government in the context of a TCA. As part of that process, the federal government commits to collect and administer taxes imposed under provincial or territorial legislation. The province or territory is then paid its share of the taxes collected.243

These fundamental features allow a general comment on the Canadian tax system. Uniformity creates a framework of fiscal neutrality in investment decision across the country. In addition, an amount of competition is retained among the provinces mainly through rates’ variation. This plays a crucial part in preventing distortion of

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competition between richer and poorer provinces. Thus, given the uniformity of tax base and formula, a coordination of rates would inevitably render richer provinces asymmetrically more appealing, as compared to poorer ones. So, disparate tax rates enhance healthy tax competition. Finally, 'equalisation payments' are also made by the federal government to support the provinces with limited revenue raising capacities. It follows, therefore, that the Canadian fiscal system is sufficiently uniform to successfully tackle market inefficiencies arising from the interaction of disparate rules.

Due to the features set out above, the current Canadian tax system can be, for the EIM, a path worth considering. In light of this, it is useful to go through some key structural points and also run through the fiscal history which marked its evolution into what it is today. Knowledge of the historical process is always a useful tool in assessing how/if aspects of the Canadian system can fit into the framework of the EIM.

II. Fiscal Federalism in Corporation Tax

Corporation tax is levied at both federal and provincial/territorial level. The provinces and territories hold their own taxing rights. In principle, they enact tax rules individually but the administration and tax collection is run by the federal government, with the exception of Alberta, Ontario and Québec. These three provinces have opted out of conceding the corporate tax administration and collection to the federal government. It should be noted, though, that Ontario

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They consist of remittances which, in practice, have existed since the Confederation in one form or another. The modern – explicit – system was introduced in 1957. Further, the Constitution Act of 1982 refers to the principle of equalisation as a federal responsibility. Since 1967, the formula for calculation of the equalisation amounts has been based on a national average standard, which is taken to reflect a province's tax capacity. See: RW Broadway and PAR Hobson, Intergovernmental Fiscal Relations in Canada Canadian Tax Paper No 96 (Canadian Tax Papers, Canadian Tax Foundation, Toronto 1993) 40 et seq. (hereinafter Broadway and Hobson).
typically entered the Single Administration of Corporate Tax following signature of a Memorandum of Agreement on 6th October 2006. Single corporate tax instalments will begin in 2008 for tax years ending on or after 1st January 2009.\textsuperscript{245}

The so-called ‘abatement’\textsuperscript{246}, fixed at 10 percent of corporate taxable income, sets out the context of interrelation between the federal government, on the one hand, and provinces and territories, on the other. It involves a reduction by the federal government of personal and corporate income taxes to make room for provincial and territorial taxes. That was a development of 1961 when the Tax Rental Arrangements were replaced by the Federal – Provincial Fiscal Arrangements Act. To comply with the new tax framework, the provinces and territories introduced their own personal and corporate income taxes (PIT and CIT).\textsuperscript{247} Under the currently applicable regime, the taxes charged by the provinces either offset the ‘abatement’ or impose an even higher tax burden.

Canada does not operate a group taxation system. There is, therefore, no consolidation or loss relief scheme. Arguments highlighting risks of tax abuse were put forward against the possibility of transferring inter-province losses.\textsuperscript{248} Taxation is at company level only. Uniform rules apply to defining the tax base in the provinces and territories which have transferred the administration and collection of taxes to the federal government. In practice, little divergence from the mainstream rule can be identified in the schemes so far in force in Alberta and Ontario.\textsuperscript{249} Further, if a company is liable to tax in more than one province or territory, the tax base is coupled with a uniform formula for the allocation of revenues to the eligible jurisdictions. The formula replaced a system of separate accounts in 1962. It is

\begin{footnotesize}
\textsuperscript{245} For this new development, see: Canadian Revenue Agency (ed), \texttt{<http://www.cra-arc.gc.ca/whatsnew/items/ctau-e.html>} and \texttt{<http://www.cra-arc.gc.ca/whatsnew/items/ctau-qa-e.html>} accessed 26 April 2007.

\textsuperscript{246} This is also referred to by the term 'tax points'. For a definition of concepts, see: Centre for Constitutional Studies (ed), \texttt{<www.law.ualberta.ca/centres/ccs/keywords.php?keyword=63>} accessed 26 April 2007.

\textsuperscript{247} Ibid.

\textsuperscript{248} Bird and Brean 1411.

\textsuperscript{249} J Harvey Perry, ‘Taxation in Canada’ Canadian Tax Paper No 89 (Canadian Tax Papers, 5th edn Canadian Tax Foundation, 1990) 168-169 (hereinafter Harvey Perry (1990)).
\end{footnotesize}
useful to note that these common rules partly offset the disadvantage caused by the absence of group taxation. This is achieved through preventing tax base overlap and double taxation.

As the provinces retain entitlement to determine the tax rates and have sovereignty over their revenues, the system remains decentralised to a considerable degree.\(^{250}\) The basic tax rate at federal level is 38 percent and drops to 28 percent following the ‘abatement’. Further, the net tax rate is 12 percent for corporations granted with Small Business Deduction. All other corporations are subject to corporate tax at 21 percent. Each of the provinces and territories with a Tax Collection Agreement accommodates two rates: a lower and a higher one. The former applies to income either eligible for the Small Business Deduction or within limits set by each province or territory. In that category, the lowest rate is hosted by New Brunswick, fixed at 1.5 percent, whereas 5 percent is the highest, charged by Newfoundland and Labrador together with Nova Scotia. The higher rate, being the default rule, ranges between 11.5 percent in the Northern Territories to 16 percent in Prince Edward Island and Nova Scotia.

Inter-corporate dividend payments made in Canada are tax-free. No withholding tax is imposed at source and exemption applies at residence. Further, foreign-source income is not taxed by the provinces. The uniform formula apportionment is employed to distinguish between foreign and domestic revenues of a corporate entity. This allows double taxation to be limited to the foreign state and federal government relations. In any case, DTCs are usually in place in that context and provide relief. Internally, the uniform formula minimises the possibility of having the same income taxed by more than one province. Then, through abstaining from taxing foreign income, provinces/territories rule out the likelihood of overlap between tax bases operated by provinces and states of source.

\(^{250}\) The data provided in this paragraph concerns rates in effect on 1\(^{st}\) January 2007 and is limited to provinces and territories with a Corporate Tax Collection Agreement with the federal government. This means that figures for Alberta, Ontario and Québec are not included. The information is made
III. A Brief Historical Survey

The allocation of taxing entitlement between the federal government and the provinces is a reflection of Canada’s colonial past as well as of major historical events of the Twentieth Century.

According to the British North America Act (BNA Act) of 1867, which founded the Confederation of Canada, the national government was granted unrestricted powers to levy taxes. In contrast, the provinces’ jurisdiction was limited to direct taxation. In that context, federal powers could be delegated to the provinces to be used for a purpose within the provincial competence. Prior to that, import duties were the main source of revenue for the provinces. Those were, however, conceded to the federal government under the BNA Act, which left the provinces with direct taxes, being very unpopular at the time. It is true that the range of direct taxes which the provinces could impose was quite broad, comprising property taxes, death duties and income taxes. On the other hand, the imposition of direct taxes involved considerable political cost, due to their unpopularity. The outcome of this situation was that the Federal Authorities had to reimburse the provinces for the debts arisen, due to the loss of revenues, through subsidies.


It should be noted that the BNA Act was succeeded by the Constitution Act in 1982. One of the most significant changes introduced has been the transfer of formal control over the Constitution from Britain to Canada. The incorporation of provisions for constitutional amendment into the Act of 1982 (Sections 37-49) is a major reflection of this. The BNA Act, unlike most constitutions, contained no amending formula, which meant that changes had to be enacted by Acts of the Parliament of the United Kingdom. Those acts were known as the British North America Acts. Ever since in force, the Constitution Act has been revised ten times to accommodate minor amendments.

Harvey Perry (1990) 150.


ibid 18.
It is evident from the above that, as early as the foundation of the Canadian Confederation, there has been a strong presence of central government. The provinces were dependent on the federal state at the time, mainly due to having been deprived of indirect taxation which was their primary source of revenue. It was clear that, in the first half-century of the Dominion, imposition of direct taxes could not generate self-sufficiency.

The gradual shift towards direct taxation had a definite impact on the evolution of Canadian fiscal federalism. The first step in that process was the imposition of direct taxes by the provinces. By 1896, corporation taxes, succession duties and personal income taxation amounted to 10 percent of total provincial revenues. The provinces had no choice but resorting to levying direct taxation since the federal subsidies soon proved inadequate to meet their budgetary needs. That was especially so when the provinces engaged into development infrastructure works. In the aftermath of these initial developments, the central authority was further enhanced during World War I. More specifically, the federal government imposed a form of corporation tax (i.e. War Profit Act) for the first time in 1916. Shortly after this, a question was brought before the Privy Council about whether the Parliament, in imposing taxes at federal level, exceeded its constitutionally conferred powers. The finding of the Court confirmed the existence of concurrent jurisdiction (i.e. federal government and provinces) over direct taxation. In the decades that followed, the federal government gradually strengthened its entitlement to impose direct taxes.

The above developments added considerably to the aspect of uniformity in the Canadian corporate tax system. This also allowed the federal government to provide solutions in the course of the 1930s' depression. It coped successfully with alleviating, through re-distribution, the problems arising from divergence in revenues among the provinces.

255 ibid 20.
256 ibid 23; Harvey Perry (1990) 18.
Another major precedent in Canada’s fiscal federalism is connected with the renunciation by the provinces of their rights to collect personal and corporation taxes. That had been a development during World War II which led the provinces to confer the competence to levy personal and corporate income tax on the federal government. It was done in return for compensation. Those ‘Tax Rental Agreements’ of the war period paved the way to attempts made by the central government to maintain control over direct taxes after the War. The provinces, however, objected to such a prospect, which forced the government to work out a compromise proposal in 1947. According to that, the provinces would ‘rent’ their taxes to the central government in return for a payment. In addition to that, they would be allowed to levy corporation tax at 5 percent to be collected by the federal government. All provinces, with the exception of Ontario and Québec, became members to those agreements, known as the ‘Tax Rental Agreements’. That system lasted until 1962 but new agreements had to be signed every five years. The agreement of 1952 achieved a wider consensus, as it was also signed by Ontario. The Dominion government proposed an additional formula favouring it.

The agreement of 1957 triggered the introduction of equalisation payments, which strongly reflects the integration objectives of Canadian fiscal federalism. It brought forth a change in the method of calculating the compensation. This was now fixed as a percentage of the revenues collected from the rented taxes. Alternatively, the provinces could levy their own taxes at rates determined by the federal government. A rebate would then be allowed against federal tax liability. However, under the pressure of the poorer provinces, being disadvantaged under the new regime, the federal government reacted by offering equalisation payments.

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257 Caron v The King [1924] AC 999 which confirmed Bank of Toronto v Lambe (1887) 12 AC 575.
258 La Forest 25.
259 ibid 25-27; J Harvey Perry A Fiscal History of Canada: the post-war years (Canadian Tax Foundation, Toronto 1989) 383 (hereinafter Harvey Perry (1989)).
261 La Forest 27; Harvey Perry (1989) 383: the equalisation payment was fixed ‘...to bring the per capita yield of the three taxes involved (i.e. Personal and Corporate Income Tax and Estate Taxes)
In 1962, Tax Rental Agreements were replaced by the Federal-Provincial Fiscal Arrangements Act. By virtue of that, the federal government conceded part of its taxing entitlement to the provinces/territories through an abatement amounting to 9 percent of corporate profits. In addition, it offered free collection of the provinces’ income taxes. This concession was provided on condition that the provinces and territories enacted rules, identical to the federal ones, for the purpose of determining the tax base and the profit allocation mechanism. Ontario, Québec and Alberta made use of an opt-out. With the exception of the recent Memorandum of Agreement signed by Ontario with the federal government, they still levy and collect corporate taxes independently.

The framework of 1962 outlines the current balance of powers between the central government and the provinces in Canada. The provinces and territories levy corporation tax and determine the applicable rates freely. At the same time, the central government managed to retain a dominant position in determining the details of the scheme. Thus, the provinces and territories were still under the obligation to comply with the federal rules on the tax base, rate structure and formula for profit allocation. In that way, Canadian fiscal federalism maintained a significant degree of uniformity. Even the three so far non-participating provinces, in practice, did not diverge highly from the federal rules on the tax base and formula construction.

In the years that followed, the provinces achieved an increase in the share which they were given by the federal government through ‘abatement’. For the period between 1967 and 1971, the abatement amounted to 10 corporate income tax points.

up to the level of the average per capita yield in the two wealthiest provinces, then Ontario and Québec’.  

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262 La Forest 34: Another one percent was given to the Provinces by amendment in 1967.  
263 ibid 31.  
264 In the case of Alberta, there has been an initial participation in the federal-based arrangement and subsequent withdrawal in 1981.  
266 Broadway and Hobson 40.  
In 1972 and 1977, the federal government conceded additional tax points to the provinces in the field of personal income tax.\textsuperscript{268} The corporation tax remained stable at an abatement of 10 percent. The above could be a challenge to the dominant position of the federal government. Again, however, the centrally-led uniformity of specific rules witnesses that the federal authorities still set the rules in a number of key issues.

IV. Commentary

This historical survey of corporate taxation in Canada demonstrates that the current situation is the outcome of a long process. The creation of one powerful authority which would preserve links with metropolitan Britain seems to have been the main reason for establishing the Confederation in 1867.\textsuperscript{269} At the same time, the provinces, which used to be separate colonies, preserved their integrity. This is reflected in their jurisdiction to impose taxes and their discretionary power to set tax rates. Overall, the system contains the least of distortion if compared to those of the USA or Switzerland.

It has been suggested that certain features of the Canadian corporate tax system (i.e. uniform base and apportionment and free determination of rates) could contribute to creating an efficient group taxation structure for the EIM. It is certain that, if the EIM is to opt for the path of regulation, as it seems to have been doing so far, the Canadian system represents an almost ideal prospect. It should be expected, though, that steps will be difficult to accomplish, given the absence of a centrally placed authority in the EC. The historical development relevant to taxes in the EC is marked by a dominance of the national states and is therefore highly fragmented. By contrast, Canada featured, mainly for reasons linked to its colonial past, a dynamic

\textsuperscript{268} Broadway and Hobson 39.  
\textsuperscript{269} ibid 4; La Forest 18.
central authority which managed to successfully claim taxing powers. An additional
demonstration of the central authority’s power is that most of the provinces and
territories were convinced to align their systems.

In the absence of a setting favourable to a centralised approach, efforts to achieve
some degree of uniformity in the EC should possibly start from the lower-tier (i.e.
the Member States, which, by analogy to Canada, correspond to the provinces and
territories). No centrally-imposed taxation is in the mid-term schedule of the EC,
which implies that the possibility of creating a central taxing authority is out of
question. Therefore, both the historical past and the existing structure of the EC
confirm the need to design a tailor-made European system.

Part B: Switzerland

I. An Overview

Switzerland is organised as a Confederation which comprises twenty six (26)
cantons. In allocating tax jurisdiction among the different levels of government, the
starting line is that, by default, taxing power is held by the cantons: ‘they exercise all
powers which are not assigned to the federal power’. By implication, federal
competence to tax exists to the extent that the Federal Constitution expressly confers

270 Althaus-Houriet, ‘Law of Taxation’ in F. Dessermontet and T. Ansay (eds), Introduction to Swiss
Law (3rd edn Kluwer Law International, the Hague 2004) 217; P Locher, Einführung in das
interkantonale Steuerrecht (2nd edn Stämpfli Verlag AG, Bern 2003) 27 et seq.
271 Federal Constitution of 18 April 1999 arts 3 & 128; this corresponds to Federal Constitution of 2
May 1874 art 41ter(5). See also U Hufelin and W Haller, Schweizerisches Bundesstaatsrecht (5th edn
Schulthess, Zurich 2001) 313.
specific taxing rights on the Confederation.\textsuperscript{272} Such constitutional authority may only be granted directly by the people and a majority of the cantons and is subject to renewal by them.\textsuperscript{273} The last vote in connection with direct taxes and VAT was held in 2004.\textsuperscript{274} Federal jurisdiction may be either exclusive or concurrent with cantonal jurisdiction.\textsuperscript{275} In the field of direct taxation, in particular, the Confederation shares the taxing power with the cantons and municipalities. Municipalities impose taxes in the form of surcharges on cantonal tax and are granted competence through delegation by the cantons.

The tax system of the Swiss Confederation has a past of extensive disparity.\textsuperscript{276} In corporation tax, each of the cantons used to operate its own tax base and formula for apportioning its tax share up until the end of the 20\textsuperscript{th} century. It was only when the THL\textsuperscript{277} came into effect on 1\textsuperscript{st} January 1993\textsuperscript{278} that an amount of uniformity was achieved.\textsuperscript{279} The current regime involves common rules in defining the tax base which, however, do not extend to tax scales, rates, deductions and allowances.\textsuperscript{280}


\textsuperscript{274} Ibid.

\textsuperscript{275} Lenz 204.


\textsuperscript{277} Bundesgesetz über die Harmonisierung der direkten Steuern der Kantone und Gemeinden (StHG), 14 December 1990. Federal Constitution of 18 April 1999 art 129; this is art 42quinquies of the Federal Constitution of 2 May 1874 (as amended by the Referendum of 12 June 1977).

\textsuperscript{278} This date for entry into force was fixed by the Swiss government on 3 June 1991.

\textsuperscript{279} The cantons were given an 8-year period of transition to bring their tax regimes in conformity with the Tax Harmonisation Law. The deadline was set on 31 December 2000. In this regard, an issue was whether, in the course of the transitional period, the cantons could still adopt laws conflicting with the Tax Harmonisation Law. The matter attracted controversial answers. See X Oberson, Droit fiscal suisse (2\textsuperscript{nd} edn Helbing & Lichtenhüsn, Basel 2002) 18 (hereinafter Oberson).

Neither does the harmonisation effort touch upon the rules for allocation of a company’s taxable profits to the eligible cantons. Therefore, each canton calculates its share pursuant to its own rules.

Another important aspect of the Swiss tax system is the contribution of the Federal Tribunal to combating inter-cantonal double taxation. Despite the existence of a constitutional clause which lays down a prohibition of inter-cantonal double taxation\(^1\), this matter has not been tackled by law so far. Yet, the Federal Tribunal has sought to alleviate the occurrences of double taxation by setting out, through its jurisprudence, rules that deal with tax base overlap.

The evolution of the Swiss tax system from a long-sustained fragmented structure to a more harmonised regime is of interest to any EC positive integration initiative. The same is true for the jurisprudence of the Federal Tribunal in solving double taxation issues. There are points of similarity but also crucial discrepancies between the Swiss Confederation and the EC. All this is useful to consider in view of the EC group taxation harmonisation project.

II. Fiscal Federalism in Corporate Tax

The Federal Constitution was amended, by referendum held on 12\(^{th}\) June 1977\(^2\), to place a more explicit obligation on to the Confederation to harmonise federal, cantonal and municipal taxes. The Bill on the Harmonisation of Direct Taxes of the

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1. Federal Constitution of 18 April 1999 art 127(3) (Federal Constitution of 2 May 1874 art 46(2)): the prohibition of the avoidance of inter-cantonal double taxation is governed by the case law of the Federal Tribunal since the Swiss Parliament never adopted statutory law in this regard.

Cantons and Municipalities reached the Swiss Parliament in 1983. It was, however, successfully passed by both Chambers, together with a Bill on Federal Direct Tax Law, only on 14th December 1990. Following expiry of the period provided for request of a referendum, the government fixed 1st January 1993 as the date for entry into force of the THL. The cantons undertook to adjust their regimes in line with THL by 31st December 2000.

The THL takes the form of a framework law (‘législation de principe’ or ‘loi-cadre’, ‘Grundsatzgesetz’) which is addressed to the cantonal legislator and not to the citizens. In light of this, it gives detailed guidelines but still leaves the cantons with a certain scope of discretion in defining the tax base. Harmonisation covers the tax subject, tax object, time of assessment, tax procedure and criminal aspects of tax law. Yet, the tax scale, rates, credits and allowances have not been included in the harmonised items and remain highly differentiated. It follows that the THL in Switzerland retains a significant degree of tax competition in inter-cantonal relations, mainly being the result of diversity in tax rates. This is all the more so, considering that equalisation transfers remain small in scale.

As mentioned earlier, the Swiss Constitution incorporates a prohibition of double taxation in an inter-cantonal context. No laws have yet been enacted to implement the respective provision of the Swiss Constitution. Some approximation has, though, been achieved through the jurisprudence of the Swiss Federal Tribunal, which has

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284 Carey et al. 12, Dafflon 17-18.
287 An additional element is that most of the Cantons (similar to the Federal Government) historically levied corporation tax at progressive rates fixed on the basis of the company’s return on equity. This is still maintained extensively.
288 The prohibition of the Federal Constitution is limited to tax liability arising within an inter-cantonal context. It does not thus extend to international double taxation.
laid down principles to tackle double taxation. Over the years, these precedents of the Federal Court filled the gap created by the lack of legislation. This body of principles of jurisprudential origin is often referred to as the ‘case law of inter-cantonal tax law’. It should be noted that, in terms of hierarchy, it is placed at the same rank as federal law, which means that it overrides cantonal rules in the event of conflict. Finally, since 1st January 2001, the THL prevails over the jurisprudential rules on double taxation where there is a contradiction.

The Federal Tribunal has given the following definition of double taxation: ‘There is a case of double taxation when the same person is subject to tax by the tax law of two cantons for the same (taxable) item and in the same assessment period’. To the end of tackling double taxation, the court formed conflict rules. The aim has been to determine the legal and factual connections which allow a canton to bring an individual under its tax jurisdiction. In interpreting the provision of the Federal Constitution on the prohibition of double taxation, the court came up with a general construction. That is, a taxpayer should not bear higher taxes in a certain canton because the taxpayer is not exclusively taxable in that canton but, instead, also bears tax liability elsewhere. Illegitimacy therefore arises when the taxpayer, subject to tax in more than one canton, suffers an overall higher tax burden than if tax liability were incurred in one canton only.

A critical matter, especially in exploring the Swiss tax system as a useful tool for the EC, is that it does not contain specific provisions applicable to groups. There is,
namely, no availability of tax base consolidation, loss transfer or profit contribution - not even at the federal level. As a result, Switzerland cannot provide an EC-wide system of group taxation with input as regards the entitlement to group membership or the methods for tax base integration. Yet, it can still be of relevance in connection with the apportionment of cross-border revenues to eligible jurisdictions.

III. A Brief Historical Survey

Switzerland\textsuperscript{298} accommodates the least centralised and most disparate system of corporate taxation among states organised in the form of a federation.\textsuperscript{299} Thus, it has consistently favoured tax competition among the cantons. Having always been a Confederation, Switzerland maintains a looser form of unity among its constituent parts. That could make it a source of useful example for the EC. A brief historical survey could assist in this regard, through highlighting analogies and points of divergence.

Switzerland became a Confederation of Cantons in 1848.\textsuperscript{300} Before that, it was a Confederation of States until the end of the 18\textsuperscript{th} century. Further, that period was followed by an unsuccessful attempt to be united under the name of ‘Helvetic Republic’ (1798). It was initially given a Federal Constitution, which was later revised totally to become the Constitution of 2\textsuperscript{nd} May 1874. The Swiss Constitution contains two key clauses in connection with taxation: (i) Article 129 (ex-Article 42)

\begin{itemize}
  \item \textsuperscript{297} Ibid 93-94
  \item \textsuperscript{299} Carey et al. 5-6.
  \item \textsuperscript{300} Higy (1970) 2.
\end{itemize}
on setting the principles for harmonisation of, among others, direct taxes;\(^{301}\) and (ii) Article 127(3) (ex-Article 46(2)) on the prohibition of double taxation in inter-cantonal transactions.\(^{302}\)

In conformity with international practice, the cantons primarily derived their revenues from indirect taxes prior to foundation of the Swiss Confederation in 1848. However, they were driven to switch to direct taxation as early as the mid-19th century. That move was a necessity then, as the Federal Constitution allocated customs duties to the exclusive competence of the Confederation.\(^{303}\) Considering that indirect taxation constituted the main source of revenue at the time, the cantons were left with inadequate resources. This rule still stands today: customs duties and stamp tax, together with tobacco and beer tax, taxes on petroleum and natural gas, are the main taxes under the exclusive taxing jurisdiction of the Confederation.\(^{304}\)

As said, revenues from direct taxes were given to the Cantons by the Constitution. The Confederation was, therefore, precluded from imposing income taxes. In the second half of the 19th century, direct taxes levied by the cantons, in principle, took the form of an annual net wealth tax. Then, it was at the turn of the century that a gradual shift towards income taxes at cantonal level started to materialise.

In the meantime, the Confederation also engaged into charging income tax in the wake of World War I.\(^{305}\) Authorisation was based on a temporary constitutional amendment, which was never given permanent status. In the years that followed, the

\(^{301}\) 1 The Confederation shall establish principles on the harmonization of direct taxes of the Confederation, the Cantons and the Municipalities; it shall take into account the efforts of the Cantons to harmonize their taxes.

2 The harmonization shall concern tax liability, tax object, taxation period, and procedural and criminal law on taxation. Harmonization shall not cover tax scales, tax rates, and tax-exempt amounts.

3 The Confederation may issue regulations against arrangements granting unjustified tax advantage’ (art 129 (ex-art 42) of the Federal Constitution of the Swiss Confederation of 18 April 1999 as on 15 October 2002).

\(^{302}\) ‘Intercantonal double taxation is prohibited. The Confederation shall take the necessary measures’ (art 127(3) (ex-art 46(2)) of the Federal Constitution).

\(^{303}\) Lenz 201.

\(^{304}\) ibid 204-205; Higy (1970) 6.
Confederation vested itself with 'emergency powers' to charge income taxes during World War I and II as well as over the economic depression. However, to date, the Confederation has not been given permanent entitlement to impose income and general turnover tax. Jurisdiction is limited in time and is renewed by referendum. Over the 19th and until the late 20th century, despite some initiatives taken, no direct tax harmonisation project came into fruition. Therefore, Swiss direct taxation was marked by the simultaneous application of a variety of disparate cantonal systems. Further, Federal Income Tax, known as 'War Tax', was added in 1915. The outcome was market distortion and extensive double taxation. In parallel, though, there was a significant degree of inter-cantonal tax competition which allowed the system to remain functional and balanced.

In light of this, the constitutional revision of 1977 opened the way to initiatives which led to the THL by placing an explicit obligation on to the Confederation. Details on this have been provided earlier in this section on Switzerland.

IV. Commentary

The post-THL system of direct taxes in Switzerland suffers less distortion than the previous regime. It is apparent that the existence of a harmonised tax base reduces the frequency of double taxation. Differential tax rates may cause some distortion of investment decision and impair neutrality. Yet, this disadvantage is offset by the fact that they create tax competition in the market and do not cause double taxation. On

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305 Lenz 202.
306 ibid 202-203.
307 ibid 203.
308 see generally F Cagianut, ‘Art 42quinquies’ in J-F Aubert and others (eds), Kommentar zur Bundesverfassung der Schweizerischen Eidgenossenschaft vom 29. Mai 1874 (Helbing & Lichtenhahn Verlag AG, Basel 1996) 2 et seq. (hereinafter Cagianut).
309 Lenz 202.
the other hand, double taxation is still part of the system, mainly due to discrepancies among the cantons’ profit allocation mechanisms. Those have remained outside the rules on harmonisation. It should be mentioned, though, that the Federal Tribunal\textsuperscript{310} has produced jurisprudence aimed at combating double taxation caused by overlap over inter-cantonal profit allocation. This is based on the principle of prohibition of inter-cantonal double taxation.

Switzerland is a system which, prior to the THL, resembled the current structures of the EU in direct taxation. More specifically, the lower-tier of government appears more significant than the centre, since the power to levy taxes rests by default with the cantons. Further, the contribution of the Federal Court to creating an integrated market has been remarkable and resonates with the ECJ. The Court has notably produced an entire body of judge-made law through interpreting a clause of the Federal Constitution on the abolition of double taxation. These analogies render the Swiss system of interest to the EC. Thus, it could possibly be claimed that how the Swiss structures have evolved could be close to a future image of the EC.

Indeed, it should be stressed that the two systems also incorporate fundamental differences. The absence of federal-level EC governance in fiscal matters is the most crucial among the points of divergence. Further, the ‘equal treatment’ jurisprudence of the ECJ has started to pave its own path and shares only a few common features with the Swiss Federal Court’s case law on the abolition of double taxation.

Some comparisons could be drawn between Switzerland and the EC. Yet, the situation in the EJM appears more discouraging when it comes to the prospects for harmonisation. Apart from TEC art 293 encouraging the abolition of double taxation, there is no other provision in the Treaties placing an explicit obligation for

\textsuperscript{310} Avi-Yonah (1991): [...] The Federal Tribunal also established some rules governing the allocation of the tax base. Under these principles, property and income are generally taxable based on the domicile of the beneficial owner, which in the case of a corporation can be its place of creation or its place of effective management (so that a corporation can be taxed in two Cantons, but not more than two, on a domiciliary basis). Real estate is taxable based on situs. In addition, other Cantons can tax the property and income of a corporation that has a permanent establishment in the Canton. [...]
harmonisation in direct taxation. Further, even TEC art 293 is addressed to the Member States and not to a central authority. It should be remembered that, in Switzerland, the initiative on harmonisation was only taken when the constitution was revised to place an obligation on to the Confederation itself. In the EC, there is no central authority with a competence to levy direct taxes. Rather, tax is imposed by the Member States. Considering that the States have persistently shown reluctance about entering into negotiations on tax matters, harmonisation projects are not likely to reach fruition any time soon.

Part C: The United States of America

I. An Overview

The US system\textsuperscript{311} of sub-national taxes\textsuperscript{312} cannot be regarded as a centralised one. Yet, neither is it decentralised to the extent that the Swiss system used to be before


\textsuperscript{312} The term 'sub-national taxes' is used here in connection with taxes imposed at the level of US States. It should be noted that, in the systems of a number of US States, one may also come across the term 'Franchise Tax'. This originates in the property tax that States were allowed to impose on property located within a State. Given the prohibition by the Commerce Clause to tax inter-state commerce, Franchise Taxes, being construed as a property tax on values derived from business income, were treated as constitutional. By contrast, substantially identical taxes labelled as income charges would have fallen within the ambit of the prohibition. For more details, see SL Gordon, 'The United States of America' in IFA (ed), Taxation Issues in a Federal State and Economic Groupings with Concurrent Taxing Authorities vol 21a (Kluwer Law International, the Hague 1996) 3, 8 (hereinafter Gordon).
the THL came into force. Further, the tax base, the rates and the mechanism for profit allocation do not enjoy uniformity across the federation.

As regards the tax base and FA, the range of disparities remains relatively limited because the differentials of each State often have the federal tax base as a common starting point. In addition, there is a type of formula which is widely acknowledged as the standard one. It is quoted as the ‘Massachusetts Formula’ and comprises three equally-weighted factors (i.e. property, payroll, sales). Individual States in the US normally make adjustments to the ‘Massachusetts Formula’, for the purpose of adapting it to their priorities.

In tax rates, the adverse effects of tax competition and of income shifting are considerably alleviated through integrating lower-tier and federal-level taxes. To give full relief, integration should take the form of a full credit provided at federal level against lower-tier taxes.\footnote{313 Musgrave (1987) 217-219.}

State tax liability is computed in a number of US States, pursuant to the group taxation concept referred to as ‘unitary taxation’ or ‘combined reporting’. More specifically, the tax base, which becomes subject to apportionment, accommodates the taxable profits of an entire unity of business. Such unity usually comprises the results (or part of the results) of more than one entity. That is because the criteria for qualification as a unitary business function independently of legal form. Details on this will be given in Chapter 6, which explores possible tests of entitlement to group membership.

The US system of sub-national taxes reflects a market which seeks to achieve unification through free-trade. The objective of a unified market in the US does not pass through harmonisation aiming at neutrality.\footnote{314 Gordon 4.} Instead, integration has been expected to advance in the field of taxes through the far-reaching interpretation
given by the US Supreme Court to two federal constitutional clauses: the Commerce and Due Process Clauses. The two concepts will be discussed briefly below as part of the historical review which follows.

**II. A Brief Historical Survey**

The US Constitution provides for dual sovereignty between the federal government and the states. The starting line is that the former is only given limited rights enumerated in the Constitution whereas the states are in principle assigned powers by default. This is stated in the Tenth Constitutional Amendment (1791), which reads: ‘the powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people’. In the field of taxes, the division of competence follows the above general rule. The framers of the Constitution were thought to have afforded individual citizens more protection through this separation of competences.

Regarding federal taxes, Article I, Section 8, Clause 1 of the Constitution vests the Congress with the power: ‘... to lay and collect taxes, duties, imposts and excises ...’. Yet, this power remained significantly curtailed until the Sixteenth Constitutional Amendment was passed in 1913. The federal government was namely precluded from charging income tax on individuals. That was the outcome

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315 The US Constitution was signed on 17 September 1787 and was ratified in 1789.
317 For a full version of the US Constitution: <http://www.law.cornell.edu/constitution/index.html>
319 ‘The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration’ (Amendment XVI (1913)).
of the interpretation given by the US Supreme Court\textsuperscript{321} to the following constitutional clause: ‘all duties, imposts and excises shall be uniform throughout the United States’.\textsuperscript{322} The Sixteenth Amendment brought forth a change to this situation and ever since, the Congress has legislated personal income tax. In contrast, the Supreme Court had acknowledged the right of the federal government to impose corporation taxes prior to the Sixteenth Amendment. Those were found to be indirect taxes, implying that they were not required to be subjected to ‘uniform apportionment’.

The US States’ competence to levy tax faces restrictions by two fundamental constitutional principles: the Commerce Clause and Due Process. Both concepts are broadly construed in the Constitution and do not contain any explicit reference to taxation. However, the jurisprudence of the US Supreme Court developed an extensive tax-specific interpretation of the two clauses over the years. It thus devised tests that fix the balance of power in levying taxes within a federal framework. The aim is to protect interstate commerce from multiple and discriminatory taxation.

The discussion below of the Commerce and Due Process Clauses will be limited to a brief historical survey and a review of the fundamental principles. The aim is to provide a background which will allow a better understanding of US group taxation at sub-federal level (i.e. combined reporting).

(i) The Commerce Clause\textsuperscript{323}

\textsuperscript{321} Pollack v Farmers’ Loan & Trust Co., 158 U.S. 601 (1895).
\textsuperscript{322} Article 1, Section 8, Clause 1 of the U.S. Constitution.
The Commerce Clause is enunciated in the US Constitution through a short statement:

[The Congress shall have power] … to regulate commerce with foreign nations, and among the several states, and with the Indian tribes.\(^{324}\)

This is a very broad construction which has served as a legal basis for a huge amount of jurisprudence in a period of over two hundred years. Indeed, the Commerce Clause has evolved into one of the key US constitutional principles. Over time, various attempts were made to define the concept and diverse tests were put forward by the US Supreme Court.\(^{325}\)

In the field of taxes, the Commerce Clause has mainly featured in jurisprudence in the form of a prohibition of either interstate commerce (‘among the several states’) or foreign commerce (‘with foreign nations’). Further, state taxation is an area of strong presence of the commonly referred to ‘dormant’ Commerce Clause.\(^{326}\) That is a judicially-created concept which imposes a prohibition on the US States to regulate interstate commerce. The constitutional language does not contain any such explicit wording. Neither is there evidence from the Philadelphia Convention’s debates that a negative aspect of the Constitution was in the Framers’ intention.\(^{327}\) Rather, the provision in principle reads as an affirmative grant of power to the Congress whilst it stays silent about the rights and obligations of the states.

\(^{324}\) Article 1, Section 8, Clause 3 of the U.S. Constitution.

\(^{325}\) For a comprehensive survey of the tests which marked the history of the Commerce Clause, see Bittker, Regulation of Interstate and Foreign Commerce (Aspen Law & Business, New York 1999) (hereinafter Bittker).


\(^{327}\) Bittker 6-4.
It was in 1824 that the Supreme Court released its first judgment on the Commerce Clause written by Chief Justice Marshall.\textsuperscript{328} The facts of the case dealt with the interstate freedom of navigation. In delineating the scope of the Commerce Clause, Marshall’s conclusion clarifies that this is not limited commodities (as one of the litigants claimed): ‘Commerce, undoubtedly, is traffic, but it is something more: it is intercourse. It describes the commercial intercourse between nations, and parts of nations, in all its branches...’.\textsuperscript{329} This statement confirmed that the contours of the Commerce Clause were not limited to goods but also extended to services.

The first state tax statute reached the Supreme Court to be tested for compliance with the Commerce Clause in 1829.\textsuperscript{330} The facts involved the ‘dormant’ Foreign Commerce Clause and dealt with a state licence tax imposed on importers and wholesalers of foreign goods. The court ruled that the Import-Export as well as the Foreign Commerce Clauses were violated. In 1873, this judgment was followed by a case in the field of the ‘dormant’ interstate Commerce Clause.\textsuperscript{331} The tax in issue was compared to a customs duty and was invalidated by the Court.\textsuperscript{332}

Since the Commerce Clause was first applied by the US Supreme Court, the line which distinguishes in-state from interstate commerce has often been re-drawn. In the aftermath of Gibbons, which took a restrictive approach to the states’ right to regulate commerce, the Justices of the US Supreme Court held opposing views on scope of the Commerce Clause. Justice Johnson, concurring with the majority, developed an interpretation which viewed the power granted to the Congress as exclusive: ‘...the grant, of this power carries with it the whole subject, leaving nothing for the state to act upon’.\textsuperscript{333} An opposite view which pointed to concurrent jurisdiction was set forth by Chief Justice Taney: ‘...the mere grant of power to the

\textsuperscript{328} Gibbons v Ogden 22 U.S. (9 Wheat.) 1 (1824) (hereinafter Gibbons); for a commentary on the implications of this judgment, see Bittker 1-8 – 1-16.
\textsuperscript{329} Gibbons 189-190.
\textsuperscript{330} Brown, 25 U.S. (12 Wheat.) 419 (1829).
\textsuperscript{331} State Freight Tax, 82 U.S. (15 Wall.) 232 (1872).
\textsuperscript{332} FP Schoettle, ‘Commerce Clause Challenges to State Taxes’ (1991) 75 Minnesota Law Review 907, 921.
\textsuperscript{333} Bittker 6-9 & 6-10.
general government cannot [be properly construed] to be an absolute prohibition to the exercise of any power over the same subject by the States. Cooley came as a compromise between the above contrasting positions and introduced the distinction between ‘national’ and ‘local’. Thus, the US States were precluded from commerce regulation to the extent that the issues ‘are in their nature national, or admit only of a uniform system, or plan of regulation’. States are then free to regulate on matters ‘best provided for, not by one system...but by as many as the legislative discretion of the several States’. 

In Smith v Alabama in 1888, the Court initiated a different test based on the distinction between ‘direct’ and ‘indirect’ impact on commerce. That allowed a wider scope for regulation to the states. In 1938, the ‘Multiple Taxation Doctrine’ came to the fore but was short-lived. It was soon replaced by a revival of the direct/indirect distinction which became again relevant when a judgement was issued on Freeman v Hewit. A prohibition was placed on ‘any state taxation imposed directly on an interstate transaction’, irrespective of that being fairly apportioned and non-discriminatory.

This test which put form over substance was overturned in Complete Auto in 1977. It was this case that launched what evolved into the so-called ‘four-prong test’ of the ‘dormant’ Commerce Clause. A Michigan corporation challenged the constitutionality of a Mississippi gross receipts tax which it had to bear for the ‘privilege of ... doing business’ in Mississippi. The test is structured as a set of four claims which should be raised and proved by the taxpayer to successfully challenge

332 ibid 6-12 & 6-13.
333 Cooley v Board of Wardens, 53 U.S. (12 How.) 299 (1851).
334 Ibid.
335 Smith v Alabama 124 U.S. 482 (1888).
337 Freeman v Hewit 329 U.S. 249 (1946).
338 Ibid 8-34.
the constitutionality of a state tax law. It follows therefore that state taxes are in principle legitimate unless the taxpayer proves that the clause is infringed. This makes the Commerce Clause a positive test, which can partly be in contrast to the EC state of affairs. Thus, if a domestic tax law is challenged before the ECJ in the context of infringement proceedings, the Member State should provide evidence of its legitimacy. That is the opposite starting point to the Commerce Clause.

For state taxes to be in compliance with the Commerce Clause, they should:
(a) tax activities with a substantial nexus to the taxing state;
(b) be fairly apportioned;
(c) not discriminate against interstate commerce; and
(d) be fairly related to services provided by the state ('speaking with one voice').

The test has attracted some criticism for being unclear in certain respects.

The nexus requirement appears identical to the test attached to the Due Process Clause. It has been submitted that the Court may have wished to respond to both clauses but the taxpayer’s pleadings lacked reference to Due Process. This view does not however appear to carry a lot of credit in the aftermath of Quill. In this case, the Court noted that ‘the Due Process and Commerce Clauses, while similar, impose distinct limits on the taxing powers of the States’. It was namely held that the requisite degree of nexus differs under each of the two clauses. More specifically, the Commerce Clause was found not to have significantly evolved after

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343 The judgment reads: ‘[…] no claim is made that the activity is not sufficiently connected to the State to justify a tax, or that the tax is not fairly related to benefits provided the taxpayer, or that the tax discriminates against interstate commerce, or that the tax is not fairly apportioned […]’ (Complete Auto 287).
344 The Due Process Clause will be discussed under the next title (Part C, Section II, Title (ii)).
345 Bittker 8-36.
346 Quill Corporation v North Dakota 504 U.S. 298 (1992) (hereinafter Quill); read also Moore 1447 et seq.
347 Quill 305.
Bellas Hess, which presupposed, as a minimum, some physical in-state presence. In contrast, Due Process appears to have moved on. It now suffices that the seller purposefully directs its commercial activity to the residents of the state (the ‘minimum contacts’ criterion).

Another noteworthy aspect of the four-prong test is that it does not rule out multiple taxation. This became a requirement later under the Foreign Commerce Clause. It will be shown in later chapters of this thesis that, to tackle multiple taxation, the tax base of each combined group should be computed under uniform rules. In addition, the States should share the same formula in apportioning the group revenues.

In discussing multiple taxation and its relation to the Commerce Clause, the concept of fair apportionment is of some relevance. It is namely doubtful what objective fair apportionment is set to pursue. Following Container, decided only months after Complete Auto, fair apportionment was linked to ‘internal’ and ‘external consistency’. Thus, these concepts were considered by the US Supreme Court in connection with apportionment formulae in general. It should be noted, though, that no link was explicitly drawn to the ‘fairness’ of apportionment. To be internally consistent, ‘the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed’. External consistency was revised in Goldberg v Sweet to be construed as follows: ‘... whether the State has taxed only that portion of the revenues from the interstate

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349 Quill at 306-308; Swan brings forth the view that a ‘substantial nexus’ under the Commerce Clause is close to ‘minimum contacts’ under the Due Process. Further, he points that Quill does not hold that the Commerce Clause threshold is lower or higher than the Due Process threshold. See: JA Swan, ‘State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective’ (2003) 45 William and Mary Law Review 319, 372-373 (hereinafter Swan).
350 It is namely doubtful what objective fair apportionment is set to pursue. Following Container, decided only months after Complete Auto, fair apportionment was linked to ‘internal’ and ‘external consistency’. Thus, these concepts were considered by the US Supreme Court in connection with apportionment formulae in general. It should be noted, though, that no link was explicitly drawn to the ‘fairness’ of apportionment. To be internally consistent, ‘the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed’. External consistency was revised in Goldberg v Sweet to be construed as follows: ‘... whether the State has taxed only that portion of the revenues from the interstate
activity which reasonably reflects the in-state component of the activity being
taxed.\textsuperscript{355}

Considering that no renunciation of multiple taxation is contained in the Commerce
Clause, it has been sought to give fair apportionment such a dimension. Yet,
arguments can be raised against this view. One point is that the Court felt the need to
add, as part of the Foreign Commerce Clause\textsuperscript{356}, a separate prong on the risk of
multiple taxation.\textsuperscript{357} Further, in Container, the Court found the outcome of the
apportionment to be fair, regardless of the existence of multiple taxation.\textsuperscript{358} So, no
safe conclusions can be drawn.

Discrimination, despite having first been invoked as early as in 1869, has not been
elaborated on through jurisprudence to have its scope precisely delineated.\textsuperscript{359} In
cases, its construction appears to reflect discrimination under the EC Treaty. It is
thus a bilateral test which does not aim at uniformity in a multi-state context. Each
state shall treat in-state taxpayers and out-of-state taxpayers similarly.\textsuperscript{360} Finally, in
Armco\textsuperscript{361}, the Court created more ambiguity when it tested the existence of
discrimination against ‘internal consistency’ tests.

Two years after Complete Auto, the initial four-part test was supplemented by two
additional prongs. This second version was created by the US Supreme Court in
Japan Line for application to facts of the Foreign Commerce Clause. In that context,
the following should be examined:\textsuperscript{362}
(a) the risk of multiple taxation; and
(b) the impairment of federal uniformity (or of the so-called ‘one voice’).

\textsuperscript{355} ibid 261.
\textsuperscript{356} Japan Line Ltd v County of Los Angeles 441 U.S. 434 (1979) (hereinafter Japan Line).
\textsuperscript{357} Moore 1450-1451.
\textsuperscript{358} ibid 1452.
\textsuperscript{359} ibid 1457.
\textsuperscript{360} ibid.
\textsuperscript{362} Japan Line 451.
Regarding point (a), it should be noted that the Court denounced an absolute prohibition of multiple taxation. That was interpreted as, in practice, taking a minimum of multiple taxation as allowable.\footnote{189}

\textit{(ii) The Due Process Clause}

The Due Process Clause\footnote{364} became part of the US Constitution by virtue of the Fourteenth Amendment, which reads:

\begin{quote}
... nor shall any state deprive any person of life, liberty, or property, without due process of law\footnote{365}
\end{quote}

The principle echoed by Due Process could possibly be traced as far back as the Magna Charta in 1215. It was then that King John made certain concessions to the English noblemen, of which one was that he would not deprive them of life, liberty or property, except according to the ‘law of the land’.\footnote{366} In 1344, the term ‘due process’ featured for the first time when King Edward III was forced by the Parliament to accept a statute that would restrict his excessive power.\footnote{367}

A general comment on the Due Process Clause in the framework of direct taxes is that it takes the form of a ban on extraterritorial taxation. The scope of this rule is specified through tests introduced by jurisprudence of the US Supreme Court. One generally-construed test consists of the question whether a tax has been levied without going through the due process of law. If the answer is in the affirmative, the

\footnotesize{\textit{Footnotes:}}

\footnote{189}{\textit{Container} 189.}
\footnote{365}{Amendment XIV (1868).}
\footnote{366}{JM Gora, \textit{Due Process of Law} (National Textbook Company in conjunction with the American Civil Liberties Union, 1977) xi (hereinafter Gora).}
\footnote{367}{Gora 1-2.}
taxpayer is then found to have suffered an unconstitutional deprivation of property. In *Moorman*\(^{369}\), the Court set out a two-part test for Due Process:

(a) There should be a *minimal connection* (or nexus)\(^{370}\) between the taxable activity and the taxing state;\(^{371}\) and

(b) The income attributed for tax purposes should be *rationally related* to values connected with the taxing state.\(^{372}\)

Finally, as regards the requisite nexus for taxation, it has been discussed earlier under the Commerce Clause that, following *Quill*, physical presence is no more one of the tests.

### III. Commentary

It is risky to draw analogies between market integration in the US and the processes applying in the EC. The US approach is marked by the constitutional principles of the Commerce and Due Process Clauses. Those feature a very broad statutory construction and differ fundamentally from the tests of ‘equal treatment’. The US concepts were given tax-related content mainly through the jurisprudence of the Supreme Court. This is probably the only common element they share with the principles of non-discrimination/non-restriction in the EC. It is obvious that the US constitutional clauses put forward an understanding of market integration which


\(^{370}\) On the concept of nexus and its interrelation to the Commerce Clause, read generally *Fatale*.

\(^{371}\) Apart from *Moorman*, see also *Bellas Hess* 756; a similar test was set forth in *Miller Bros v Maryland*, 347 U.S. 340, 344-345 (1954): ‘...some definite link, some minimum connection, between [the taxing state] and the person, property or transaction it seeks to tax’. An additional dimension of Due Process is proposed in *Wisconsin v J.C. Penney Co.*, 311 U.S. 435 (1940). Namely, state taxation should actually be a return for the use of public services by the taxpayer. This seems to reflect the rationale behind the nexus theory.

\(^{372}\) This condition resonates with the test set out in *Union Tank* in 1919, according to which the tax should fairly reflect the taxpayer’s activities in the state: *Union Tank Line v Wright*, 249 U.S. 275 (1919).
strikes the EC as unfamiliar. Still though, this different approach is worth considering ahead of embarking on devising a group taxation scheme of EC-wide scope. This is because the US provides the only existing case of group taxation at sub-federal level.

It has been explained that the aim to tackle multiple taxation is absent from the four-prong test applying to the interstate aspect of the Commerce Clause. Still though, the chances of tax base overlap are reduced through the exclusion of interstate commerce proceeds from the states’ tax base. This outcome is further supported through the nexus requirement of Due Process. On the other hand, double taxation in the EC is tolerated by the ECJ to the extent that it does not infringe the freedoms. This is surprisingly so, despite the existence of TEC art 293 placing an explicit obligation on to the Member States to abolish double taxation. The provision is, though, not enforceable before the Court due to its lack of direct effect.

Another element of market integration in the US is the non-discrimination clause contained in the Commerce Clause’s test. However, that has by no means led to jurisprudence of a similar significance to that of the ECJ in the field. More specifically, the concept appears to incorporate a comparison of in-state with out-of-state situations. Yet, in this broad construction, the prohibition looks almost all-inclusive, as it lacks comparability tests and justifications akin to those produced by the ECJ. The fact that the US Supreme Court has not focused on refining the non-discrimination prong may also indicate that this is not meant to be the decisive test.

The mechanisms which contribute to market integration in the US, being inherent in the Federal Constitution, do not find an equivalent in the EC. In the tax field, they have been developed to fit the needs of ‘unitary taxation’. The term will be discussed in detail in Chapter 6 of this thesis.\textsuperscript{373} Briefly, it uses business unity as a test for entitlement to group membership. This is a concept unknown in Europe.

\textsuperscript{373} Chapter 6, Part A, Section III.
Despite divergence and lack of familiarity with concepts, the US experience in sub-federal corporate taxes is invaluable for the EC. The US notably constitutes the only international precedent in applying group taxation (i.e. ‘combined reporting’) at a sub-federal tier. This is a fact which, irrespective of the possibility to draw analogies to the EC, renders the elements of US combined reporting essential knowledge for EC policy-making.

Conclusion

European initiatives may derive inspiration from existing systems of sub-national taxes only up to a certain extent. The difference between the intra-EC situation and any of the above countries is significant. This is obvious in both the degree of integration and amount of sovereignty conceded to the central administration. Divergence is primarily caused by the fact that the EC does not hold any decision-making power in regard to direct taxes. Rather, this lies with the Member States instead.

It has been shown that, despite divergence at sub-federal level, the existence of a strong federal state is critical. In Canada, the involvement of central government had a decisive impact on gradually structuring a relatively uniform system. Thus, the Constitution provides for a general jurisdiction to tax at federal level and this in principle stretches to cover all taxes. The US system of sub-federal corporate taxation benefits from using the federal tax base and the ‘Massachusetts’ formula as starting points. A common feature between the US and the EC relates to the

‘activist’ role of the US Supreme Court and the ECJ in interpreting the Federal Constitution and the EC Treaty respectively. Since, however, the two constitutional traditions are so different, there is not much for the EIM to derive a useful example from. In Switzerland, it has always been the cantons that, by default, held the tax-imposing power. Direct taxation at federal level was just an additional system to the already existing cantonal ones. The Federal Court played a significant part in preventing double taxation. However, inefficiencies persisted. It is noteworthy that, in the absence of action by the Confederation, the cantons proved incapable of leading the way towards direct tax harmonisation over the 20th century. This is an additional indication of the importance of federal-level governance in accomplishing integration.
4. POLICY APPROACHES TO CORPORATION TAXES IN CLOSELY INTEGRATED MARKETS

Introduction

Tax initiatives at European level have always been guided by the principles of European integration, as those have kept evolving in the context of the EIM over the years. The first two chapters of the thesis gave an outline of the background on negative and positive integration in the area of corporate taxes. The focus has been on aspects that impact strongly on the taxation of groups. In this fourth chapter, an attempt will be made to place the EC initiative on corporate taxation within a broader scope of principles that permeate business taxation in integrated markets and notably the EIM.

The word which could possibly summarise the long-term fiscal vision for the EIM is ‘efficiency’. This is aimed to materialise within a framework of what is referred to as ‘competitive neutrality’. Over the half century of existence of the EC, various attempts have been made to legislate the way to market efficiency in the field of corporate taxes. The process indicates that efficiency in the EIM is broadly envisaged as the outcome of harmonisation (or coordination) of the disparate national systems. From a tax perspective, heavy compliance burdens, lack of transparency, elements distorting commercial decisions, double taxation are in

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375 See generally, WF Fox, MN Murray and L Luna, ‘How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured’ (2005) 58 National Tax Journal 139-159 (hereinafter Fox and Murray).

principle incompatible with efficiency. On the contrary, achievement of a certain amount of fiscal neutrality across a market appears to be the most decisive step towards an efficient setting.

Internationally, there are divergent approaches to the above. The opposing theories accommodate the views of the ‘free marketers’, on the one hand, and the ‘regulators’, on the other.

The discussion that follows will seek to clarify where the current EC policy plans stand on the spectrum between regulation and tax competition. Further, it will also explore possible paths to efficiency through the examination of certain features of the EIM that guide harmonisation. Finally, analysis will be carried out of the objectives to which the EIM should conform as well as of the instruments to be used for coordination/harmonisation.


There are two main policy approaches to tackling fiscal inefficiencies within multi-jurisdictional markets: regulation and tax competition. The proponents of regulation seek, through legislative measures, to alleviate the adverse consequences caused by the interaction of disparate laws. Such consequences normally involve, market distortion, being the result of double taxation, increased costs or disadvantageous treatment of cross-border situations. On the other hand, the ‘free-marketers’ insist that the market itself contains inherent forces to move into some approximation and
tackle distorting elements.\textsuperscript{377} In multi-jurisdictional markets, the second theory is the least restrictive of state sovereignty. This is a key reason why, despite its inefficiencies, it has gained some support internationally.

The regulators target at rectifying, through common regulation, features which cause market inefficiencies. Thus, a harmonised system of corporate taxation could simplify tax compliance obligations for businesses active in more than one jurisdiction within an integrated market. In principle, common rules should eliminate fiscal obstacles to transactions or dealings within a market. In its extreme version, such a system should involve a uniform tax base and rates across the market, which creates a fiscally neutral environment without tax competition.

However, a complete elimination of tax competition among the constituent parts of an integrated market could have adverse effects. It would thus grant the financially most powerful jurisdictions with a definite comparative advantage over the smaller markets. This is especially so, to the extent that there is no provision for cross-border consolidation.\textsuperscript{378} Further, in a context of detailed market regulation, achievement of perfect neutrality may not always bring a positive effect. If the common rules are rigid or extremely complex\textsuperscript{379}, they are likely to foster an inefficient market. More specifically, they would create a negative impact on competitiveness, which is in contrast to the target set in Lisbon in the year 2000.\textsuperscript{380}

The free-marketers' position does not appear entirely clear in the literature. A part makes reference to tax competition as an alternative to regulation, which also leads

\textsuperscript{380} In March 2000, the European Council in Lisbon placed the following mandate: 'The Union has today set itself a new strategic goal for the next decade: to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion' – Lisbon European Council 23 and 24 March 2000, Presidency Conclusions, para 5.
to harmonisation (or, at least, approximation) but through a different path.\textsuperscript{381} Another view takes disharmony and inefficiencies as inherent – though not necessarily harmful - in tax competition practices.

Tax competition may lead to an approximation of rates, which could also involve fixing rates at a lower level than if agreed on through legislation. Apart from that, however, the tax base is very difficult to allow for approximation without regulation. In this respect, the effort to attract investment may probably bring some ‘similarity of concepts’\textsuperscript{382} in the definition of the tax base. Still though, distortion would persist, as similarity is not enough to obliterate tax base overlaps and disparities. In terms of end-result, if the envisaged objective is to attain neutrality, this does not seem to be tackled effectively. Namely, attenuating disparities does not guarantee a fully neutral investment decision.

The opposing approach admits that, in a non-regulated market, advantage can be gained from ‘economic benefits derived from [maintaining] tax differentials’.\textsuperscript{383} Such a system is certainly more flexible than a coordinated structure applying across a larger area. Further, neither does it appear necessarily irreconcilable with the vision of an integrated market. An example is the USA market which clearly favours de-regulation and tax competition. In contrast, higher transaction costs, being an outcome of the absence of regulation or divergence, create a setting likely to impede cross-border trade.

Part B: Corporate Fiscal Policies in the EIM

\textsuperscript{381} Avi-Yonah (1991) (page numbering not available on Lexis-Nexis).
\textsuperscript{382} Cockfield 61.
\textsuperscript{383} ibid 48.
I. Is Regulation Necessary for Corporate Tax Coordination in the EIM?

There are no provisions in the EC Treaty that accommodate a specific requirement for corporate tax coordination/harmonisation. TEC art 293 addresses a task to the Member States to enter into negotiations for the purpose of securing the abolition of double taxation. However, the provision does not place any precise obligation on to the Member States to reach the specified aim. No direct effect is produced, meaning that there is no entitlement to an action before the ECJ for non-implementation. It follows that the Treaty does not expressly envisage that direct taxation should ultimately take the form of a unified framework across the EIM.

Given the absence of a power-conferring provision in direct taxes, legislative measures in principle contain a reference to the EC Treaty as a whole and TEC art 94. The latter incorporates a generally construed clause ‘... for the approximation of laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market’. It follows that measures of approximation are welcome, though not required. Indeed, a reference to the broad objectives of the single market does not fulfil the requirements for direct effect. Therefore, the Member States do not infringe the EC Treaty if they remain inactive in direct taxation. Thus, to conform to the EC Treaty, it normally suffices that national tax systems comply with the discrimination/restriction rules of the

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384 ‘Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals: [........] the abolition of double taxation within the Community’ (TEC art 293).
385 For instance, see the Preambles to the P-S and I & R Directives. For an outline of the successful legislative initiatives in the field of direct taxation, see earlier in this thesis Chapter 2, Part B.
386 ‘The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market’ (TEC art 94).
This points, however, to a totally separate process from coordination/harmonisation.

The initiative of the European Commission for an EC-wide approach to group taxation clearly evidences a policy choice favouring regulation, rather than competition. The envisaged framework goes far beyond the Treaty requirements for eliminating fiscal impediments to, and discrimination against, free movement. Meanwhile, the absence of an enforceable task for regulation could allow the view that the EC could have opted for an approach favourable to competition.

Setting the creation of an efficient market as the ultimate objective, the question boils down to the following: should attainment of that objective necessarily require elimination of disparities in the Member States' tax systems?

The answer to such a question is not straightforward. Since there is no legal obligation to move in either direction, any choice is primarily a policy decision. As said, the documentation produced by the European Commission in the field of company taxation puts forward initiatives for harmonisation of national systems.

It appears that a certain amount of uniformity is necessary to achieve market efficiency. This can be identified, even in countries such as Switzerland and the US where priority has clearly been given to tax competition.

In the case of Switzerland, the introduction of the Tax Harmonisation Law (THL) has brought a policy change into the system. Uniformity through regulation now occupies an important area (i.e. tax base definition) in the tax system of the Confederation. This does not, however, imply that competition is no more part of the

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387 For a detailed discussion of the terms ‘discrimination’ and ‘restriction’ and of the tests on equal treatment, see earlier in this thesis Chapter 1, Part A, Section II.


389 See Chapter 3, Parts B and C respectively.
system. As explained in the section on Switzerland, the rates, allowances and a number of other items remain under the competence of the cantons.

The US has developed a concept of market integration which does not pass through regulation. In effect, double taxation is tolerated in that context. Yet, there are certain features in the US tax system allowing some approximation of laws at sub-federal level. As corporation tax is charged at two levels in the country, the federal tax base essentially constitutes a starting point in the formation of the US States' tax bases. Therefore, a degree of uniformity is achieved by the sole existence of a federal-level liability to tax. The situation is similar as regards the mechanism for profit allocation used by each US State, for the purpose of computing its share in a corporation's (or unitary group's) tax base. It is the 'Massachusetts Formula' to which most US States make adjustments to fix their individual formulae. In addition, the objective of market integration in the US is pursued through the jurisprudence of the Supreme Court on the Commerce and Due Process Clauses.

None of the above parameters is relevant to the EIM. This is primarily due to the absence of taxing jurisdiction at EC level. That is, in devising a group taxation system for Europe, Member States' sovereignty should remain intact. Indeed, the fact that cross-border intra-EC transactions are governed by DTCs is demonstrative of a strongly intergovernmental framework. So far as foreseeable, Member States would not concede their exclusive competence to impose and collect taxes to any authority at EC level. Apart from a policy of regulation, there is no

390 Locher 1213-1214.
393 For details on the 'Massachusetts Formula', see: Chapter 9, Part B, Section I.
394 For a comprehensive discussion of the concepts, see: Chapter 3, Part C, Section II.
396 This is also in line with the principle of subsidiarity. See generally: M Gérard, 'Neutralities and Non-Neutralities in International Corporate Taxation: An Evaluation of Possible and Recent Moves' (2002) 48 ifo Studien 533, 549 (hereinafter Gérard (ifo Studien)); Klaver and Timmermans 185.
other mechanism in the EC to ensure a certain amount of unity. The ECJ is bound by
the bilateral nature of the non-discrimination/non-restriction tests which may only
have an impact of limited scope on the system. It follows that regulation inevitably
appears the most promising path to an efficient market.

A further question could probably involve the extent to which regulation should
apply. Namely, this boils down to which aspects of a tax system should be
harmonised and which left to the Member States' decision. There will be elaboration
on this in the substantive chapters that follow. Regulation at EC-level is expected
to cover the elements of the tax base and the FA. In contrast, the rates will remain
within the responsibility of the Member States. Finally, certain administrative
practices will most probably require uniform treatment, as they are crucial in
enhancing market efficiency.

II. Principles for an Efficient Setting for Groups of Companies
in the EIM

1. The Objectives

When it comes to corporation tax harmonisation initiatives, the mandate adopted by
the European Council of March 2000, held in Lisbon, is the starting point:

The Union has today set itself a new strategic goal for the
next decade: to become the most competitive and dynamic
knowledge-based economy in the world, capable of

\[397\] That is: Chapter 5 on the administration of the system; Chapter 6 on the rules for group definition;
Chapter 7 on the methods for computing the group tax base; Chapter 8 on the territorial scope of the
group; and Chapter 9 on the mechanism for apportioning the group base to the eligible states.
sustainable economic growth with more and better jobs and
greater social cohesion.\textsuperscript{398}

The mandate provides an important guideline for reference in designing a group
taxation system for the EIM. There is thus an emphasis on improving economic
welfare in the Community\textsuperscript{399}, which is an objective dating back to the Treaty of
Rome.

As discussed in chapter 2, the European Commission has taken legislative initiatives
in the field of company taxation. The aim has been to create a framework allowing
the efficient allocation of resources within the market.\textsuperscript{400} The meaning of this,
according to the Staff Paper of 2001, is that fiscal elements which currently distort
economic activity and investment within the EIM should be eliminated.\textsuperscript{401} Distortion
usually impacts on the decision about the type of investment, its location and
financing. In contrast, where resources are efficiently allocated, investment decision
is not tax-driven.\textsuperscript{402} Rather, it should be based on other factors, such as economic
infrastructure, availability of qualified work, short and medium-term outlook in
different markets and countries, accessibility of markets, and so on.\textsuperscript{403}

In the Staff Paper\textsuperscript{404}, market efficiency is treated as being a concept almost identical
to (fiscal) neutrality. Indeed, the analysis contained under the title ‘efficiency’ is one
of ‘neutrality’. Possibly, ‘simplicity’, ‘certainty’ and ‘transparency’, analysed
separately in the Staff Paper\textsuperscript{405}, could also be treated as contributing, alongside
neutrality, to an efficient setting. In terms of substance, all the above concepts
represent features which should appear in a common regulatory framework applying
to MNEs in the EIM.

\textsuperscript{398} Presidency Conclusions, Lisbon European Council of 23 and 24 March 2000, para 5.
\textsuperscript{399} Staff Paper 15.
\textsuperscript{400} Ibid.
\textsuperscript{401} Ibid 15-16.
\textsuperscript{402} Staff Paper (executive summary) 2.
\textsuperscript{403} Ibid 3.
\textsuperscript{404} Staff Paper 26-27.
The Current Structure of the EIM

In the area of direct taxation, the EIM appears significantly fragmented. With the exception of few specific items where Community legislation has created common rules, the market consists of as many tax systems as the number of Member States. It follows that, in EC Law, the approach to direct taxation is, in principle, inter-governmental and the Freedoms are its focus. The extensive jurisprudence of the ECJ in direct taxation is based on interpreting ‘equal treatment’ in a context of discrimination or restriction. This is a bilateral test which does not enhance uniformity within the EIM. Neither can neutrality be achieved in such a context. The process does not go beyond the requirement for compliance with the EC Treaty.

Challenges Presented by Closely Integrated Multi-Jurisdictional Markets

Efficiency in a closely integrated market primarily presupposes a legal framework which can accommodate increased capital mobility. Further, complexity is inherent in multi-jurisdictional structures in the field of direct taxation. This is due to the fact that the taxing power is exercised by more than one jurisdiction within the same market. Such a market is usually organised in a federal-type structure.

Where activity remains strictly local, it does not go any further than the contours of a specific sub-national unit. In those cases, tax treatment is, in principle, straightforward. Namely, corporation tax would be charged according to the federal

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405 ibid 28.
406 see Chapter 2 of this thesis.
407 For details on the structure of those tests, see Chapter 1, Part A of this thesis.
and relevant local rules. However, activity which does not extend beyond a sub-
 federal unit constitutes a rare occurrence in closely integrated markets. Indeed,
 economic action is normally carried on across the market's constituent units due to
 increased mobility of capital. Thus, the market should be economically integrated
 enough to be treated as one single area.

Activities that involve crossing sub-national jurisdictional borders could typically be
tackled through the established principles of source and residence. That is the
current regime in the EIM. There is, though, a series of reasons why it is not
satisfactory to deal with such facts through traditional international tax concepts. ⁴¹⁰
The main argument relates to the objectives pursued by an integrated market.
Priority is thus given to eliminating impediments to the mobility of capital among
the constituent units. The aim is to achieve fiscal neutrality of investment decisions.
The focus is, therefore, not on protecting the tax base of each constituent unit from
erosion but rather the tax revenues of the internal market as a whole. As a result, the
principal aim is not to allow defence of the integrity of individual tax bases. This is,
however, what the concepts of source and residence mainly aim at. In contrast, sub-
federal tax rules should depart from the above inter-governmental practice to best
serve increased capital mobility and business integration.

Source/residence structures, within highly integrated markets, could be vulnerable to
tax avoidance schemes deployed through income shifting and forum shopping.
These practices are considerably facilitated in such markets, as compared to the
international marketplace. That is because associated companies often treat highly
integrated markets as one single unit and become active through huge numbers of
inter-company transactions. The result is increased mobility of the factors of
production which facilitates the manipulation of systems operating under traditional
international tax principles. For instance, if the residence test is a typical one (e.g.
place of incorporation), successful tax planning will easily shift income towards the
lower-tax sub-federal units. In contrast, the abuse risk is reduced if the tax base is

allocated on the basis of ‘factors’ which function independently of both source and residence. The mechanism for profit allocation is termed Formulary Apportionment (FA). Its effectiveness largely depends on how the factors are designed to cope with manipulation risks.\textsuperscript{411}

Charging corporation tax solely on a source basis\textsuperscript{412} is a method that one often comes across in computing tax at sub-federal/sub-national level. This is a feature of Capital Import Neutrality (CIN), which means that the overall tax burden is always equivalent to liability in the jurisdiction of source. No tax should be charged at the home state jurisdiction. Such a fiscal structure can contribute some simplicity to a market of increased capital mobility. It is thus widely thought to be more effective than the traditional source/residence taxation where fiscal liability arises twice. Still though, to make sure that double taxation is eliminated, there is one additional requirement. That is, the rules of the sub-federal systems should not clash in determining the source of income.\textsuperscript{413}

A system of source/residence taxation may also be designed to give full relief by credit at residence, which creates Capital Export Neutrality (CEN). This would render the decision to invest across the border a neutral option for the taxpayer, as compared to staying within the jurisdiction of the state of residence. In such a case, though, significant administrative and implementation impracticalities are likely to arise. Namely, to the end of eliminating double taxation, a full imputation credit should be granted at residence for the tax paid at source. That is, however, a system which is hard to operate. Tax paid at source would be at the expense of the tax share allocated to the sub-federal unit of residence. Such a situation could spur on severe competition of tax rates and bases among the units of a federal structure. In support of the above concerns, it may be useful to recall that the Commission Proposal

\textsuperscript{411} For detailed analysis on FA, see Chapter 9 of this thesis; a short reference is made later in this chapter under: 2. The Instruments.

1975 envisaged a compensatory payment by the jurisdiction of source towards residence. The purpose was to partially alleviate the erosion of the tax share of residence. The mechanism involved, though, great administrative complexity. It further remains doubtful whether it could achieve equity in the division of tax shares (i.e. ‘inter-jurisdictional equity’).

Irrespective of the system applying internally, the traditional source/residence concept should be retained to regulate relations in an international setting. Traditional international tax concepts are functional within a network of bilateral relations among sovereign states in the context of which there is no integration objective. Therefore, source/residence taxation should still be applicable to computing tax liability at federal level. This concerns transactions with third countries and the application of DTCs. In the EIM, DTCs are concluded exclusively by the Member States and there is no tax imposed at EC level. In light of this, commercial activity between Member States and third countries should be taxed pursuant to source/residence rules.

**Neutrali** as the Key Concept in Integrated Markets

Within a multi-jurisdictional market, fiscal neutrality, in its absolute version, should normally involve applying a uniform tax base and rate. In addition, if a group taxation system is in place, a uniform formula for profit apportionment should be devised. It follows that such a structure cancels tax competition among the constituent units (i.e. the Member States in an EC context).

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417 RA Musgrave and PB Musgrave, ‘Inter-nation Equity’ in RM Bird and JG Head (eds), Modern Fiscal Issues: Essays in Honour of Carl S Shoup (University of Toronto Press, 1972) 63 (Musgrave (1972)); idem (1987); idem (1995); Staff Paper 26-27; Staff paper (executive summary) 3.
This is a situation, in principle, free of any fiscal distortion. However, that does not necessarily imply that investment decision in such a regulated landscape remains neutral. Rather, in the absence of tax competition, a comparative advantage would be created in favour of wealthier economies.\textsuperscript{419} That is because any opportunity of attracting capital through tax-friendly structures would become minimal. Therefore, complete fiscal neutrality may give rise to non-fiscal features which actually impact on investment decisions.

In light of the above, federal-type states charging corporation taxes at sub-federal level (i.e. Canada, Switzerland and the US) have introduced provisions to strike a balance between neutrality and competition. In the US, a free-market approach is reflected in the disparities of the formula factors and diverse versions of tax base applied by each US State. This is, however, offset through the integration mechanism between lower-tier and federal taxes. In the centralised Canadian system, which lies closer to regulation, competition is brought in by means of allowing free determination of tax rates. Further, in Switzerland, the Federal Tribunal has sought to reduce distortion caused by disparities in cantonal tax bases (prior to THL), rates and formulae factors. This was done by laying down general principles in interpreting the constitutional principle of prohibition of double taxation.

As said, the EIM, at its current state of development, is still far from being a fiscally neutral market. Further, since the market accommodates disparate systems, there is tax competition but its beneficial effect is often impeded due to distortions. Neutrality underlies the European Commission’s policy documents. It is thus one of the key principles to which the proposed ‘comprehensive schemes’ should conform. Those delineate the future directions for coordination of corporation taxes in Europe.

As said, a neutral scheme is marked by the absence of any fiscal element which may

\textsuperscript{418} Gérard (ifo Studien) 550; M Gérard, ‘Inter-jurisdictional Company Taxation in Europe, the German Reform and the new EU Suggested Direction’ CESifo Working Paper No 636(1) (CESifo Working Papers, CESifo, München 2002) 19 (hereinafter Gérard (CESifo Working Paper)).

\textsuperscript{419} Klaver and Timmermans 187.
distort business decisions. That normally presupposes an accomplished integration process, having reached the objective of a ‘single market’. It implies that legislative measures have been enacted to regulate all aspects of corporate taxation at EC level. The outcome should be to create one single EC-wide regime for corporate taxation.

2. The instruments

a) Formulary Apportionment (FA)

FA is a key feature which commonly applies, instead of arm’s length separate accounting, to sub-federal structures for the allocation of profit. It is widely believed that switching from transaction-based separate accounting to an approximation of profit reached through apportionment is justifiable on the following grounds: (i) to reduce costs relating to compliance with transfer pricing rules and (ii) to provide a framework for taxation which fits the integrated business structures that MNEs organise themselves in. Therefore, the contribution of FA to neutrality and efficiency primarily focuses on two areas:

(i) Combating income shifting practices towards lower-tax jurisdictions. Under FA schemes, the share taxable in each sub-federal jurisdiction is determined by the weight carried by each formula factor in that jurisdiction. By implication, the pricing of individual transactions is no more an indicator. That means transfer pricing provisions appear redundant, as there is no more incentive to engage in income shifting practices.

(ii) Drawing comparables and identifying value-added arising from economies of scale and scope may be extremely difficult in intra-group transactions. In cases of a
high degree of business integration within the internal market.\footnote{420} finding the so-called Comparable Uncontrolled Price (CUP)\footnote{421} may prove extremely difficult. Especially when it comes to global MNEs, it often happens that there are brands exclusively produced within a single large group. That makes identification of price comparables a rather tough exercise.\footnote{423} Moreover, the so-called ‘Synergism’,\footnote{424} attached to economies of scale and scope, may render a transaction-based computation of profit inaccurate.\footnote{425} This is because the group companies contribute to each other’s profitability. This share of value among the group entities cannot be depicted by separate accounting. Consequently, a traditional source/residence approach would probably not reflect this economic reality. In addition, identifying the location of source and residence may prove a complicated process within a highly integrated business.

As said, source-base taxation could be a better alternative to source/residence schemes when it comes to calculate sub-national taxes. That is because it contributes more effectively to market neutrality. It is, though, the FA, instead of source taxation, that most federally-structured countries (i.e. the US, Canada, Switzerland) have adopted, for the purpose of subjecting companies to tax at sub-national level.

There are some reasons for this policy choice. More specifically, source taxation may prevent double taxation, provided that there is no tax base overlap among the sub-federal units. It cannot, however, provide effective solutions to the difficulties of correctly identifying the location of source and specifying profit attributable to that. This is especially true in the case of highly integrated MNEs where there are shared

\footnote{420} Detailed discussion on FA is contained in Chapter 9.
\footnote{421} For a discussion on increased capital mobility and its implications in highly integrated markets, see earlier in this chapter Part B, Section II, Title I.
\footnote{422} Transfer Pricing Guidelines II-2.
\footnote{423} Musgrave (1984) 236.
\footnote{425} This is especially so, where income comes in substantial part through the exploitation of intangible property: MJ McIntyre, ‘The Use of Combined Reporting by Nation States’ (2004) 35 Tax Notes International 917 (hereinafter McIntyre (2004)).
values among the various locations. As a result, attachment to a precise sub-federal unit is often not obvious. This problem is tackled through the FA, which functions independently of the traditional principles of source/residence. Namely, the formula factors\textsuperscript{426} (under the classic ‘Massachusetts’ model: property, payroll and sales) employ more precise allocation criteria than the geographical location of income. That makes FA more appropriate than ‘source’ to fit into new commercial structures.

FA does not alone ensure achievement of fiscal neutrality\textsuperscript{427} and market efficiency through eliminating tax obstacles. That would require operation of a uniform formula across the market. In countries where FA is currently operated, such as the US and Switzerland, each State or Canton is most likely to devise its own version of the formula. Thus, income of a specific company (or, in the US, a unitary business) is apportioned to each sub-federal unit pursuant to each State’s/Canton’s own rules.\textsuperscript{428} That inevitably creates distortions in profit allocation, as it causes double taxation due to overlap in the revenues incorporated into the tax base. It follows that only a uniform formula would be in line with the objective for neutrality set by the EIM.

\textit{b) Tax Base and Rates}

If perfect location neutrality is the target, it is then clear that both tax base and rates across a multi-jurisdictional market should be uniform.\textsuperscript{429} On the other hand, if each of the sub-federal units applies a different tax base or rate, some distortion of business decision is likely to come into the picture. That will, in principle, concern the location (i.e. sub-federal unit) of investment. Still though, a setting of perfect

\textsuperscript{426} Fox and Murray; McLure holds the view that allocating profit pursuant to the factors is, in practice, equal to charging tax on each of the formula factors.
\textsuperscript{427} Gérard (ifö Studien) 550.
\textsuperscript{428} See Chapter 3, Part B, Section IV on Switzerland and Part C, Section I & IV.
\textsuperscript{429} Musgrave (1987) 198-199.
fiscal neutrality may still not be the best policy choice for the Member States.\textsuperscript{430} This is because the system may be rigid and difficult to administer or suffer non-tax distortions.

There are systems, such as the US, which accommodate significant disparities both in tax base and the methods for profit allocation. To eliminate adverse effects, there is provision for integration between lower- and federal-tier corporation tax rates. In an EU context, the potential setting looks the exact opposite. As explained earlier,\textsuperscript{431} combating distortion in the EIM places a requirement for harmonisation through regulation. A group taxation system allowing Member States to apply differential tax bases and/or variable FAs for profit allocation would clearly depart from the above objective. Yet, tax rate differences, apart from some degree of market distortion likely to impair location neutrality, do not cause double taxation. Neither do they put an additional burden on to compliance costs. Finally, differential rates do not, in principle, risk failing the test of non-discrimination/non-restriction before the ECJ.\textsuperscript{432}

The policy documents issued by the European institutions in relation to company taxation after 2000\textsuperscript{433} mark a change of approach to the determination of rates. The question arising is whether the policy choices of the new Millennium constitute an ideological shift towards the ‘free-marketers’ theory, which favours tax competition. In the 1970s, the attempts for coordination/harmonisation of corporation tax systems

\textsuperscript{430} In the context of the EU, there is always an additional element to this. It is the Member States’ sovereignty, which ends up determining policy decisions very often. In light of this, it is unlikely that a coordination process which aims at a high degree of neutrality, through a uniformity of bases and rates, is not faced with severe resistance on the part of the Member States. The compromise likely to be struck does not normally involve a dogmatically perfect solution. It is instead a deal which lies somewhere on the spectrum between the two ends. This thesis aims at analysing policies solely on the basis of technical principles. The examination of the impact that Member States’ individual interests may have on decision-making directions falls outside the scope of this work.

\textsuperscript{431} For more details, see earlier in this chapter Part B, Section I.

\textsuperscript{432} This is so to the extent that no difference in rates applies between foreign and domestic situations within each Member State; for the non-discrimination/non-restriction tests, see Chapter I, Part A, Section II.

in the EIM passed through tax rate approximation.434 The same approach was retained in the Ruding Report of 1992. Approximation was envisaged by means of setting a maximum and a minimum rate.435 On the contrary, proposals for tax rates issued after 2000 provide that those are freely fixed by the Member States.

To answer the question, one should consider that the Community legislative initiatives up to the Staff Paper of 2001 have always aimed at tackling inefficiencies of the EIM in specific matters. Therefore, the approximation of tax rates was not a proposal meant to apply in addition to a scheme of tax base uniformity. The shift from the approach of tax rate to base uniformity seems to have been linked – at least, in timing – to the so-called ‘comprehensive remedial measures’. Namely, this was the first time that the Commission communicated the broad lines of a system of corporate tax, rather than aspects that rectify specifically identified complexities. By the time that the prospect of tax base uniformity came into the picture, the determination of tax rates was left to the Member States’ discretion. Over the years, the evolution of policy choices seems to have involved a decision on whether to regulate the tax base or the rates. However, the final position has never been one of complete uniformity. It seems that a certain amount of tax competition has always been appreciated - either through the freedom to decide on the elements of the tax base or the rates.

c) The External Network of DTCs

The Member States, in principle, maintain the competence to deal with third states in fiscal relations. Briefly, the general rule on external competence is that it rests with the Member States, unless explicitly or implicitly conferred on the Community by the Treaties. The vast majority of cases fall within the so-called ‘implied competence’, of which the scope has been delineated through ECJ case law.

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435 For information about the Ruding Report, see Chapter 2, Part A.
More specifically, the existence of internal common rules is an adequate ground for claiming that external competence in the specific issue has been conceded to the EC (‘parallelism’).436 The same rule renders Community competence exclusive in the fields it covers. Further, where internal legislation is missing, external Community competence should still exist ‘insofar as the participation of the Community in the international agreement is ... necessary for the attainment of one of the objectives of the Community’437 (principle of ‘complementarity’). In this case, however, Community competence is concurrent with that of Member States.438 This usually leads to the conclusion of mixed agreements.

There are areas, such as dividend distributions, interest and royalty payments, savings taxation, in which the EC has legislated.439 In light of the above, it could possibly be argued that, in those fields, competence has de facto passed to the EC. Were such a conclusion to gain approval, the European Commission would have to be invited to negotiate, alongside the Member States, certain provisions of their DTCs.

Conclusion

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438 This conclusion arises from (he stricter interpretation of exclusive competence adopted in the following two Opinions issued in the 1990s: Opinion 2/91 delivered pursuant to Article 228(1) second subpara EEC Treaty. – ‘Convention No 170 of the International Labour Organization concerning safety in the use of chemicals at work’ [1993] ECR I-01061 (hereinafter ILO Opinion), Opinion 1/94 delivered pursuant to Article 228(6) EC Treaty. – ‘Competence of the Community to conclude international agreements concerning services and the protection of intellectual property’ [1994] ECR I-05267 (hereinafter WTO Opinion).
There are key parameters, peculiar to the EIM, which place a requirement for tailor-made structures. Overall, any proposed European scheme for group taxation should be created to meet the principles of the *acquis communautaire*.\(^{440}\)

It has been shown that a comprehensive corporation tax system at European level should serve the EIM policy objectives for neutrality and efficiency. The aim should be to devise a scheme which can best contribute to a balanced presence of tax competition and of neutrality.\(^{441}\)

To this end, a uniform tax base should be applicable across the group, whereas the tax rates can be left to the Member States for determination. The tax rate divergence may render investment decisions non-neutral but this drawback is offset by the advantages of tax competition. In any case, perfect fiscal neutrality does not normally create a neutral framework for investment, as it allows other (non-tax) differences to surface. It is also crucial that the formula for profit allocation within each group be uniform. This should comprise both the factors for apportionment and the weight allocated to them. Thereby, tax base overlap will be deterred, which should result in eliminating double taxation within the group.

EC group taxation should also be in compliance with the Treaties. Thus, the system applying internally should be coupled with international tax arrangements to allow flows to and from third countries. This need arises primarily because of the absence of federal-level taxation in the EIM.

In the following chapters, it will be explored whether (and how) the objectives discussed above can materialise within the current framework of the EIM.

\(^{439}\) For more details, see Chapter 2, Part B.  
\(^{440}\) It refers to the entire body of EU Law which is produced this far. It is divided into chapters negotiated between accession states and the EU. For the negotiations with Croatia and Turkey, the *acquis communautaire* consists of 35 chapters.  
\(^{441}\) For a brief outline of the ideological debate, see earlier in this chapter Part A.
5. Administrative Issues

Introduction

A group taxation system for the EIM is an experiment without precedent internationally. Ideas and experiences can be derived from systems applying to federal-type state entities but still, the sovereignty of EC Member States marks a difference in the EIM.\(^{442}\) Unique challenges arise in connection with both the aims to be pursued and the administration of the system. That is the result of an often contradictory coexistence of single market integration targets and Member States' competence in direct taxes.

In the analysis that follows, reference is only made to administrative features of certain US States that apply combined reporting.\(^{443}\) The systems of Canada and Switzerland cannot provide an example for the EC, as they do not accommodate group taxation structures. Rather, FA is applied to each individual company.

Having analysed the policy principles which permeate integration objectives in the EIM, the broad lines of how a group taxation system could be administered will be discussed here. The idea is thus to look at the administrative issues before moving on to exploring the individual structural elements of the EC-wide group. That is


\(^{443}\) It should be noted that the cited features of systems of certain US States are inevitably small in number. The reason has been that information on the issues researched has only sparsely been available. Therefore, this is, by no means, meant to be a comprehensive survey. Yet, it can still give an idea of the applicable structures.
because knowledge of what can be workable in practice is expected to act as guidance for any decision on the substance of each precise element.

The administration-related issues to be examined below have been organised in four parts: compliance, enforcement, dispute resolution and re-assessment of tax liability.

Part A: Compliance

The analysis that follows will focus on tax compliance obligations which present particular features in a group taxation context. The areas identified in that regard involve group registration, determination of tax periods and return filing.

I. Registration

An EC-wide group taxation system is expected to accommodate companies which, in most cases, have already registered with the national authorities. It is, therefore, in such a context that a scheme for registration of the group should fit. An option could be to allow the group to register for tax purposes only once. That would naturally be in the state of the parent company’s residence. Going through the group registration formalities in each Member State, host to at least one company eligible for group participation, would prove a non-pragmatic approach.\textsuperscript{444} Such a practice would be

\textsuperscript{444} It should be clarified that any scheme for groups should not eliminate the requirement for separate tax registration of each individual group entity. The main reason is that, when it comes to commercial establishment, certain administrative formalities in individual Member States cannot be avoided. There are thus regulatory requirements which, on top of tax registration, should be complied with. In VAT, the ‘one-stop-shop’ facility for registration makes more sense, as there is no other formality of a regulatory nature. It is currently in force in the field of e-commerce and saves third-country
costly and time-consuming indeed. It would defeat the purpose of market efficiency. Below, there is discussion of certain critical features dealing with group registration which, in the author’s view, should appear in an EC-wide group taxation system.

**Notification of Group Registration to Participating Member States**

Such a system of registration should be coupled with a mechanism of automatic notification to the tax authorities of all Member States concerned. Notably, a system of automatic exchange of information would provide a useful tool. A detailed discussion on this matter will be carried out later in this chapter under Part B (i.e. Enforcement).

The Member State of a group’s registration should be in charge of checking whether the rules for (group) membership have been complied with. It could also be an option to allow the Member States which host group subsidiaries to raise objections to the group’s composition if they consider that the rules are breached. This would be in line with Member States’ sovereignty in direct taxes. Depending on the circumstances, that could also increase the chances of approval of an EC group taxation system.

If the Member States are given the possibility to raise objections to group membership, they should be allowed a reasonable amount of time to examine the situation. For such a mechanism to function properly, it is expected that each

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suppliers of e-services from the obligation to obtain VAT numbers in each Member State they trade. There is also discussion of the possibility to extend the ‘one-stop-shop’ facility to cross-border services taxed, for VAT purposes, at the place of the recipient’s establishment.

445 Notification will follow registration of the group. So, the procedure will not take the shape of a notification for approval similar to the procedure of Merger Control in EC Competition Law.

446 If EC group taxation has been implemented as part of an enhanced cooperation scheme, then notification will be limited to the participating Member States.

447 The possibility of Member States to raise objections originates in a common feature of Administrative Law. Taxpayers with a legitimate interest are often given the right to object to Administrative Acts. The objection may take the form of either an appeal at the administrative level or an action before the court. For an example within the context of the EC, see TEC art 230 subpara
Member State should make available resources within its tax administration - possibly, through creating a special department. A group’s registration would only be treated as final upon expiry, without objection, of the specifically defined period of time. Approval of a group’s membership by all Member States concerned would then be deemed to have been obtained. Should disagreement emerge among the Member States, it would be solved through a dispute settlement system. This prospect is discussed later in this chapter under Part C (i.e. Dispute Resolution).

**Time for Registration**

A brief consideration of registration formalities applicable to national group taxation systems gives evidence of extensive disparities.

The French rules on *Régime d'intégration fiscale*[^448] require that group election must be done before the first day of the accounting period to which consolidation shall apply. Further, an official agreement should be enclosed in the election declaration.

The regulatory framework in Germany[^449] appears more flexible than the French one, in terms of the dates by which registration formalities should be completed. More specifically, it involves conclusion of a Profit and Loss Transfer Agreement (*Gewinnabführungsvertrag*) between the parent company and each of the

[^448]: *Any natural or legal person may, under the same conditions, institute proceedings ... against a decision which, although in the form of a regulation or a decision addressed to another person, is of direct and individual concern to the former*.

[^449]: *This is a system of profit consolidation on which more detail is provided later in this thesis as part of the ownership tests for entitlement to group membership (Chapter 6, Part A, Section 1) and of the rules on tax base integration (Chapter 7, Part A, Section 1)*. J Richard, ‘Comparison between UK and French Taxation of Groups of Companies’ (2003) 31 Intertax 20, 28-29 (hereinafter Richard); JA Borrat and A Bassière, ‘Report on Group Taxation in France’ in IFA (ed), *Cahiers de droit fiscal international* vol 89b (Cahiers de droit fiscal international, IFA, 2004) 271, 275-276 (hereinafter Borrat and Bassière in IFA Cahiers).
subsidiaries making part of the *Organschaft*. Following that, the Agreement should be recorded in the Commercial Register. Until the Tax Privilege Reduction Act took effect (i.e. prior to the 2003 assessment period), the system used to allow a higher amount of flexibility in complying with regulatory requirements. Namely, the Agreement could be recorded on the Commercial Register even in the year following that of initial application of the *Organschaft*’s rules. The regime which replaced those rules set forth a stricter timeline. Thus, the group registration shall now be completed by the end of the fiscal year in which the Agreement became applicable.

At the other end of the spectrum, the UK group or consortium relief involves a quite flexible structure. No obligation is placed to register as a group entity at any time in advance. Namely, group or consortium membership is gained when the claim for loss transfer is filed, which can be within a two-year period. Still though, both entities taking part in loss relief should be found to have satisfied the group membership tests over the entire accounting year in issue. In light of the above, it should probably be noted that the UK scheme is, to a large extent, an outcome of the country’s group taxation system. Since this involves no consolidation and the entities retain their integrity, the UK group relief does not give rise to significant additional administrative formalities. That gives it space for flexibility.

In California’s ‘water’s edge’, the option is given to become a group member subsequently. The taxpayer is deemed to have elected and shall be bound by the election for the remaining term of the contract. Another possibility is forced election, which may occur by reason of a tax audit. If the Franchise Tax Board

450 This is the term after which the German group taxation system is named. For details on the *Organschaft*, see later in this thesis Chapter 6, Part A, Section I.

451 For more details on the UK group relief, see later in this thesis Chapter 6, Part A, Section I; Richard 32; Y Rupal, ‘Report on Group Taxation in the United Kingdom’ in IFA (ed), *Cahiers de droit fiscal international* vol 89b (Cahiers de droit fiscal international, IFA, 2004) 685 et seq. (hereinafter Rupal in IFA Cahiers).


453 Ibid.
finds that a non-electing taxpayer is actually a member of the group, the taxpayer qualifies for a deemed election.

In considering possible solutions for the EC, an idea could be that elections are, in principle, registered at the beginning of the taxable period.\textsuperscript{454} That could probably be within the first month. Such an arrangement should allow enough time for a procedure of dispute settlement, if activated, to have been completed before the annual tax liability becomes due. Further, a mechanism should be put in place to confirm, on an annual basis, the groups’ composition and record changes in it. Equally, it should furnish the Member States with the opportunity to pronounce their objections. Thus, parent companies (in EC groups) shall bear an obligation to confirm their group’s membership to the competent authorities of their state of residence. That should be done at the beginning of each tax period. A one-month deadline should suffice for that.\textsuperscript{455} Member States will then be notified of changes, so that they can be in a position to file their objections early enough in the tax year.

\textit{The Term of the Group}

Another issue on which a decision should be reached relates to the group’s life span and changes in entitlement to group membership occurring in the meantime. In making a choice, consideration should be taken of tax avoidance risks but also, of the Lisbon Strategy objectives to make the EC ‘\textit{the most competitive knowledge-based market}’. These two factors for policy decision are often in conflict, as measures scheduled to tackle tax avoidance may be found to discourage competition

\textsuperscript{454} Even though, in national group taxation systems, the point of reference in this regard is the accounting year and not the tax year, it is the latter that should be used in the context of the EC. This is because the critical event here is to allow enough time for possible Member States’ disagreements on group composition to have been settled before tax liability becomes due. Further, since the group tax base will not be linked to financial accounts, the accounting year is, typically, not critical. In practice, however, considering that financial accounts are used as a primary source of information for tax accounts, some coordination between accounting and tax years should be worked out.

\textsuperscript{455} Confirmation is also part of the French \textit{intégration fiscale}, which requires the parent company to submit a list of the companies to be group members in the following accounting period.
in the EIM. In the analysis that follows, it will be shown how this clash surfaces in determining the term of the group.

A look into the situation of national group taxation systems reflects a situation of disparity.

In Germany, an Organschaft is registered for a minimum term of five years. Earlier termination 'for no serious reason' treats the group as not having existed at all. Sales, spin-offs and restructurings are mentioned as serious reasons for termination.

A minimum term of five years is the rule in France as well. There is, however, provision for changes in the group, which should be reported annually by the parent company on a list submitted to the tax authorities. The changes are valid for the following accounting year. Further, at the end of the accounting period, it is possible to take out companies initially declared. However, no new entities can be added.

It follows from the systems applying to both Germany and France that group membership is locked at the beginning of the tax year. If changes in group entitlement occur in the meantime, the earliest that the new companies can gain group entitlement in France is the next accounting year.

In the UK, by contrast, partly due to the lack of consolidation features in its group taxation regime, the system operates with flexibility. There is thus an annual


\[457\] Eckstein in IFA Cahiers 304-305; Graf Kerssenbrock 12.

\[458\] Richard 29.

\[459\] For an explanation of the distinction between the (often contrasting) terms used to describe tax base integration methods, see Chapter 7, Part A, Section I.
option without any obligation for a prior registration or disclosure of group members.\footnote{Endres 350.}

In California, the filing requirement is for seven years (or eighty four consecutive months) for income years beginning on or after 1st January 1994. Further, there is provision for a facility of automatic renewal as well as for a notice of non-renewal. Termination of an election prior to the contract’s expiry is, in principle, possible with permission by the Franchise Tax Board.\footnote{California Franchise Tax Board (ed), ‘Water’s-Edge Election and Contract’ (Internal Procedures Manual, September 2001) Section 3.2 Point B <http://www.ftb.ca.gov/aboutFTB/manuals/audit/water/ch3.pdf> accessed 16 June 2007.} Otherwise, for elections begun on or after 1st January 1994, the only way to avoid the permission is that the taxpayer be acquired by an unaffiliated larger entity which has not elected.

One proposal for an EC group taxation system could be to ‘lock’ the group for a defined period of time once it is registered. This would imply that no ‘new entries’ or ‘exits’ would be allowed. As shown earlier, such provisions are not a rare occurrence. They instead constitute common practice for a number of states. Within a group, such an approach contributes to legal certainty. Further, it reduces tax avoidance risks, as no easy advantage can be taken of artificial changes in holdings just for the purpose of gaining the benefits of group taxation. On the other hand, it features a certain amount of rigidity, which does not contribute to effectively pursuing the Lisbon objectives for competitiveness.

The above rule appears to be an important element of group taxation systems which do not accommodate allocation of the group tax base by FA. This is a structure typical of the national systems operated by the majority of Member States.\footnote{See Chapter 6, Part A, Section I.} Consolidation/pooling would probably be unworkable unless all participating entities were registered during the same period and for the same amount of time.\footnote{For instance, a pool comprises revenues of entities which have been part of the}
group for a full accounting year as well as of an entity which became a group member in the previous three months. In such a case, the parent company’s results would end up distorted. It would thus be risky, if not impossible, to compute, out of a ‘new entry’s’ individual tax liability, the amount of tax corresponding to the three months. This would be necessary, though, as that amount is credited against the parent company’s tax liability upon consolidation/pooling.

Another option could be to have the groups registered at the end of each tax period. In that way, only companies which remained in the group for the entire past accounting year would be eligible for membership. However, from an administrative point of view, leaving registration for the year end could prove a drawback in managing an EC-wide system. Notifying the Member States for approval of the group’s composition so late in the year would not allow enough time for resolving disputes before tax becomes due. This could indeed lead to compromising legal certainty. Namely, the group members’ tax liability would inevitably remain subject to amendment insofar as no definitive decision on the group’s composition has been reached.

In the author’s view, the adoption of FA in allocating the group tax base to the eligible Member States could possibly offer a wider range of options. Apportionment allows a company which participates in a group for a shorter period than the entire accounting year to be allocated its proper share of the tax base. Namely, complexities inherent in separate accounting, such as that of computing the credit, are no more present here. It still seems, though, that there is some room for tax avoidance through artificial changes in holdings. To the end of tackling this, Member States could agree to lay down minimum holding periods of the entities participating in a group. More specifically, instead of ‘locking’ the entire group for a number of years, it could be provided that the minimum holding period is

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463 It is not necessarily required that group companies share a common tax year. For instance, under Organschaft, tax periods do not need to coincide in terms of dates.

464 The condition for holding over a minimum period is an anti-avoidance clause contained in the P-S Directive art 4(2) and the I & R Directive art 1(10).
considered at the level of each group member. Thus, ‘new entries’ and ‘exits’ would be allowed, insofar as the respective group member has remained in the group for at least five years. The minimum life of a group will therefore be set on an entity basis and not for the entire group. That should allow some flexibility.

II. Taxable Periods

The tax year occupies different dates in the system of each EC Member State. In light of this, the question is whether the Member States should decide that one single fiscal period should apply to all members within a single group.

It can be derived from comparative data on accounting periods that national policies appear divergent.

Among a list of twelve states with group taxation systems, only two states (i.e. Australia and the Netherlands) operating full consolidation schemes require a common business year for their group entities. Further, the same applies to the US system which, despite carrying the name ‘consolidated tax group’, in practice functions as pooling. An additional comment is that, among the systems reviewed, none of those without consolidation/pooling features (i.e. UK and Sweden) places an obligation for uniform accounting years. Further, differential approaches can be identified among Organisations, with Germany allowing differences whereas Luxembourg not. Finally, a requirement for common business year also applies to a number of states with pooling systems such as Denmark, France and Spain.

In the US States’ systems of combined reporting, there seems to be a default rule of common taxable year. However, arrangements are also put in place to allow flexibility for members of the combined group which apply a different accounting
period. In Texas, the primary point of reference is the taxable year of the federal consolidated group. More specifically, if two or more members of a group file a consolidated return, the combined group’s accounting period is that of the federal group. Otherwise, the common taxable year is that of the principal Texas entity. Further, guidelines are given to make arrangements in connection with group members with a different accounting period. Similar rules govern the system in Illinois. There is thus a starting line, making the taxable year of the designated agent the rule for the combined group. Then, this is coupled with a set of guidelines on how to deal with group members which accommodate schemes that diverge from the general norm.

In principle, international practice witnesses a fragmented approach. Still though, a number of conclusions can be drawn from the above. It seems that the rules of tax return filing are of some relevance to a group member’s taxable year.

More specifically, it is certain that, where a group taxation system involves a limited degree of integration, there is no requirement for a common accounting period. That is, namely, the case in the UK scheme of ‘loss relief’ and the Swedish ‘profit contribution’. Further, another clear set of facts exists where the parent company files a single tax return on behalf of the entire group (i.e. Australia, the Netherlands and the USA). In those cases, the group members seem to always have a common taxable period.

The situation in the rest of cases does not seem to create a common norm on taxable periods.

465 See comparative table in: Endres 350-351.
468 Endres 350-351.
469 Ibid.
A first point is that a distinction can be drawn between systems of a fundamentally different structure. In most of the national systems, the subsidiaries settle their tax liability individually and then have their results pooled at the level of the parent company. A credit is provided for tax already paid. The approach taken is mixed, even though the majority of countries seem to have favoured the policy option of a common taxable year.

On the other hand, ‘combined reporting’, operated by the US States, incorporates a fundamentally different structure. It may also consist of filing separate tax returns but the taxable base of each entity is not determined individually. Rather, the group’s combined tax base is allocated to the members by FA. This creates a more integrated scheme than pooling. The examples of Texas and Illinois demonstrate a degree of flexibility. More specifically, room is given for departure from the default rule of a common tax year. Again, however, arrangements are made to allow the departing entities to fit into the group’s taxable period. This is frequently done by apportioning an entity’s yearly results. The outcome is that shares from two consecutive accounting periods are taken account of for the group tax base.

It appears that, in a system which allocates the tax base through a formula, a single taxable period across the group is a definite contribution to efficiency. However, this should not rule out the possibility of allowing some flexibility. In principle, though, to the extent that an EC group taxation scheme operates FA to determine each entity’s liability, accounting years should be fixed to coincide. Otherwise,

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473 In connection with the CCCTB, the Member States have taken a position in favour of a harmonised solution, see WG Doc 2 on Admin Issues 5.
significant coordination problems would surface. For example, the deadlines for notifying registration, proposed under Section I above, would probably lose their justification in the absence of a uniform tax year.

III. Tax Return Filings

Prior to discussing possible structures of tax return filing in an EC group taxation system, some comparative data is provided below.

Fully consolidated systems, such as those of Australia and the Netherlands, provide for one single filing made by the parent company. The US federal group taxation system also operates through one single return which is filed by the parent company on behalf of all group members. By contrast, each group entity is called upon to file its own return in tax systems classified as pooling. Those may range from Organschaft (i.e. Germany) to schemes of tax base consolidation with elimination of inter-company profits (i.e. France and Spain). At a first stage, each group member computes its own tax base, on which it pays tax. The individual tax bases are then pooled at the parent company’s level, which allows losses to be set off against profits.

When it comes to US States’ business taxation, the concept of combined reporting enters into the picture. No consolidation is involved. Namely, each group member files its own tax return with the group’s combined report appended. However, here, the amount of tax due by each group entity is not determined prior to combination,
as it happens with the *Organschaft*. Instead, tax is payable by each group member on the determined share of combined income allocated through FA.

This practice is also confirmed by individual US States' data. In New York,\(^478\) the group must file a completed combined report. In addition, each corporation must compute and show the tax which would have been due for payment if the entity filed on a separate basis. Texas operates a scheme in which the principal Texas entity is responsible for reporting on behalf of the combined group.\(^479\) It files a combined report together with all reports and schedules required by the comptroller.

The options available to an EC group taxation system in connection with tax return filing are basically two. Filing may take place at the level of the parent group company or, alternatively, the taxpayer can file a separate tax return with each eligible Member State. In principle, the above two paths roughly coincide with the alternatives put forward by the Working Group on the CCCTB project.\(^480\)

The first policy choice would most probably allow the taxpayer to deal with only one tax administration.\(^481\) The amounts of tax collected would then be passed over to the eligible Member States. Such facilitation may not, however, make a significant difference from the second option. Considering, that each Member State retains its own taxing jurisdiction, separate tax returns would need to be filed for each group entity in any case. So, the prospect of a single tax return seems to be out of question.


\(^{480}\) WG Doc 2 on Adman Issues 4-5.

\(^{481}\) This is a 'one-stop-shop' type of system. Such a scheme is in force in the field of e-services in VAT. It offers third-country operators the opportunity to register and account for VAT with the authorities of only one Member State. See: Council Directive (EC) 2002/38 of 7 May 2002 amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio
Further, the Member States may not be willing to concede their administrative control over the group entities which fall within their taxing entitlement. It is certain that any such move would risk undermining their effectiveness in the course of a future audit. Still though, despite its grave effect on Member States’ sovereignty in direct taxes, this may not be of much practical significance. It will thus be discussed later\(^\text{482}\) that the competence to audit the group may inevitably need to be conferred on the parent company. Finally, irrespective of the scheme endorsed, it is necessary that the national tax authorities be in a position to keep full record of their entities’ financial and tax accounts. This is crucial when a subsidiary leaves the group.\(^\text{483}\)

It follows that a scheme of tax return filing akin to ‘one-stop-shop’, despite its drawbacks, could be a workable solution in the EC. It does not, though, appear a necessity. The decision is most likely to be reached based on practical considerations. One example is how much of their sovereignty the Member States will consent to concede.

Separate returns would normally need to be filed in connection with the part of group income which is not apportioned. It will be discussed in Chapter 8 that business income derived from third countries may not be included in the EC group tax base. In such case, it will instead be allocated by attribution to the beneficiary entities. The same is likely to apply to dividends of a third-country source.\(^\text{484}\) Therefore, those items of income should be declared separately.

As regards dates for filing\(^\text{485}\), it will be necessary that they are arranged as fixed dates, especially if no agreement is reached on a common tax year for the group.

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\(^{482}\) See later in this chapter Part B, Section III.

\(^{483}\) For two examples which demonstrate the problems arising from a subsidiary’s departure, see IFA Cahiers’ General Report 2004 52 (2.5.1) & 55 (3.2.1).

\(^{484}\) See Chapter 8, Part B, Section III, Title 2.
Part B: Enforcement

I. Exchange of Information

A group taxation system extending across the border of a single jurisdiction should accommodate a sophisticated mechanism for the exchange of information. In such a context, cross-border information is not required solely for the purpose of deterring tax avoidance schemes. That has primarily been the focus under International Tax Law. In the case of an EC group taxation system, extensive exchange fulfils more vital functions. It is a prerequisite for the system's viability and day-to-day operation.

More specifically, the exchange of information appears to be an indispensable element of the system in the following cases:486

(i) The authorities of the parent company's state shall annually release information on group membership to all participating Member States, so that objections can be raised.

(ii) The authorities of the parent company's state shall notify the outcome of the apportionment to the Member States eligible for a share in the group tax base. If a system of single tax return is opted for, the approved allocation should be notified to the Member States. Further, a mechanism should be devised to allow the amounts of tax collected to be passed over to the entitled jurisdictions. On the other hand, if the taxpayer deals with each administration separately, the mechanisms for notification need not be very sophisticated.

485 WG Doc 2 on Admin Issues 4.
(iii) To complete a tax audit, national authorities will need to get hold of data retained by another Member State. Assistance from local tax inspectors or experts may additionally be required. This should be a frequent occurrence in the course of audits.487

Legal instruments are available, worldwide, for the exchange of information between states in the field of taxation. European states are parties to a number of them.488 The agreements differ as regards the range of taxes they cover and the forms which they allow the exchange of information to take. It is beyond the scope of this thesis to pursue a detailed examination of international (and regional) agreements/conventions/pacts for the exchange of information. Features could be derived from those experiences for the purpose of creating an EC group taxation system. A thorough study, though, should be the item of a separate research topic. The present work will only attempt to set out the broad lines of an exchange of information scheme focused on the needs of an EC group taxation system.

In considering exchange of information within such a framework, a starting point should be the Exchange of Information Directive of 1977. The Directive covers taxes on income and capital and could serve as a basis on which exchange of information within EC-wide groups could be built. The Directive, as amended in 2004, contains provisions on exchange by request489 as well as automatic490 and spontaneous491 exchange and simultaneous controls.492

486 WG Doc 2 on Admin Issues 6.
487 For more details, see later in this Part at Section III.
489 Exchange of Information Directive art 2(1).
The cases listed under points (i) and (ii) above should become subject to an automatic exchange of information, as the need to communicate facts arises on a regular basis (i.e. annually). To this end, the Member States could probably make use of the wording of art 3 of the Exchange of Information Directive. The provision does not contain any listing. Instead, it allows decision to be made by the Member States under the ‘consultation procedure’, which is also regulated by the Directive. 493

As regards tax audits (i.e. item listed under (iii) above), the concepts of exchange by request as well as of spontaneous exchange and simultaneous controls are crucial. Thus, those should be developed into fully-fledged mechanisms intended to establish a minimum common level of disclosure. Namely, highly integrated MNEs cannot be audited, where information made available to the tax authorities does not go beyond each single entity. 494 This is all the more so where a group is subject to a set of common rules for corporation tax purposes.

The question coming next concerns the degree of disclosure of data. Namely, in a dispute on the outcome of allocation between the parent company’s state and a subsidiary’s state, should the latter be entitled to have access to information on other group subsidiaries? 495 If not, how will it be in a position to challenge the allocation performed by the parent state (which holds the relevant information)? Full disclosure should be taken as a given reality at the level of the parent company’s state. That state will get hold of the entire group’s results for the purpose of computing the tax base and allocating it. Considering this, claims are likely to be put forward for extending the right to access to information to Member States hosting subsidiaries.

490 ibid art 3.
491 ibid art 4.
492 ibid art 8b.
493 ibid art 9.
494 Vertical integration and economies of scale and scope do not allow an accurate result to be achieved if each group entity is considered separately: McLure (1984) 95; Musgrave (1984) 236.
The implications of an EC group taxation system in the field of exchange of information seem far-reaching indeed. They bring forth an impressive restriction on state sovereignty.\textsuperscript{496} Still though, common rules on disclosure appear to be a necessity. Otherwise, the system will most probably fail the test in practice. The question is whether the Member States will be willing to take steps in that direction.

II. Rulings

No particular challenges are raised by the existence of divergent national systems for rulings insofar as those deal with issues of a domestic scope. So, questions on the elements of a group subsidiary's tax base can be referred to the domestic tax authorities without creating complexities.

A set of common rules across the group would be necessary when the questions referred affect the tax base entitlement of other states that host group members. For instance, if a taxpayer, being a group subsidiary, applies for a ruling touching upon group definition, consolidation or apportionment, this cannot be tackled locally. It is a group-related matter which should necessarily be dealt with centrally. A ruling on any such issue could probably be given by the parent company's state. Namely, this is encumbered with the task of determining group entitlement and with carrying out consolidation and tax base allocation. It is obvious that any such ruling creates effects for all jurisdictions involved in the specific group.

Rulings systems may be structured either as binding or non-binding. Irrespective of this, a ruling by the parent company's state on group composition, consolidation or allocation should be mutually recognised across the group. Otherwise, the system

\textsuperscript{495} WG Doc I on Admin Issues 2-3.

\textsuperscript{496} See the Introduction to this thesis for an explanation of the conflict between state sovereignty and market integration objectives.
would be entirely deprived of efficiency. Notably, if the rulings scheme is agreed upon as binding, all Member States attached to the group should comply with the decision delivered. It is apparent that a harmonised system of rulings would constitute an optimal solution. However, this is not expected to be an easily negotiable objective, as it would bring the Member States before a further restriction of their sovereignty. In light of this, mutual recognition could represent a mid-term solution. It is true that it could potentially compromise the system's uniformity. Still though, taking account of the current state of harmonisation in direct taxes within the EIM, no better prospect appears to have a chance of materialising in the near future.

On the path towards common rules, a starting point could be the Commission Communication of 2007 giving guidelines for Advance Pricing Agreements (APAs). Among other facilities, the proposed framework provides for the negotiation of bilateral and multilateral pricing agreements between tax administrations. If considered in connection with an EC group taxation system, these agreements would need to be extensively amended. The main reason is that, in most cases, the allocation of the group tax base is expected to be carried out by formula. That places potential tax base overlap on a different basis. Thus, differences in the pricing of transactions are no more the reason for disagreement. Therefore, deals in the context of an EC group will have to be brokered based on other criteria – possibly, criteria inherent in apportionment.

III. Tax Audits


498 For a proposal of the basic elements for a European tax rulings system, see: Romano 463 et seq.
The responsibility to carry out tax audits is naturally held by the authority which is competent to levy the relevant taxes. Given that the Member States in principle enjoy an exclusive power in direct taxation, tax audits in that field should typically be conducted at national level. Apart from the two Directives on Mutual Assistance, there is no other piece of EC legislation touching, directly or indirectly, upon audits. Thus, in the absence of common rules, the starting line should be that each Member State shall have competence to audit the group’s entities liable to tax in its jurisdiction. These tax audits refer to determining a single entity’s taxable revenue. That is, namely, the tax base which is added to the results of the rest of the group, for the purpose of creating the overall base.

However, a substantial difference in circumstances occurs if groups extend beyond national borders across the EC and common rules are applicable within a group. Treatment then depends on how the group taxation scheme is structured. For instance, the system of the US States does not involve a centrally performed computation of the group tax base followed by apportionment to the eligible jurisdictions. In contrast, each US State carries out its own computations individually, for the purpose of arriving at its tax share in the group.

An EC group taxation system may typically be administered by either a central authority at European level or by the Member State of the reporting group entity. The latter is in principle the parent company. Considering the lack of direct tax jurisdiction of the EC, it seems in line with subsidiarity to assign the computation of the group tax base and its allocation to the parent entity. Roughly, this is also the policy choice promoted by the European institutions. Should a scheme of

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501 Staff Paper 373 et seq.; Bersani Report II.
consolidation/pooling\(^{502}\) be applicable, the group tax base and its allocation to the
eligible Member States should be worked out by the parent entity.\(^{503}\) No
discrimination issues are likely to arise from this practice since the parent entity will
be applying common rules across the group.

It follows that, in such a context, audits should naturally be tackled at the level of the
parent entity. In this regard, it should also be clarified whether parallel audits will be
allowed. Typically, each Member State is entitled to audit the group entities subject
to its tax jurisdiction. Considering this, care should be taken to prevent chaotic
situations from occurring. Thus, auditing one group entity is likely to lead to tax re-
assessments and to revisions of accounts with an impact on the entire group.\(^{504}\) The
outcome is therefore a situation of legal uncertainty, which is difficult to operate in
practice. On the other hand, depriving the Member States of their auditing
entitlement appears a serious restriction on sovereignty. Given their so far sceptical
approach to tax integration initiatives, the Member States would not be willing to
waive their audit powers. What is more, that would confer a clear advantage on the
largest economies in the EC, which usually host parent group companies.

The above discussion allows the conclusion that a system of auditing each group
member separately would be unworkable. Despite any difficulties in decision-
making, due to Member States’ reluctance, it seems that operating audits at the level
of the parent company is the only option.\(^{505}\)

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\(^{502}\) For a detailed discussion of the concepts of ‘consolidation’ and ‘pooling’, see Chapter 6, Part B,
Section 1.

\(^{503}\) It is a separate issue whether a ‘one-stop-shop’ structure is operated to allow the filing of tax
returns and the settlement of tax liability through dealing with one single tax administration. The
matter here exclusively concerns how the computation of the group tax base and the apportionment to
eligible jurisdictions should be audited. It is irrelevant which authority processes the formalities of
collection.

\(^{504}\) See later in this chapter Part D.

\(^{505}\) This is not a necessity in US combined reporting because each State computes its taxable share
independently of all other States eligible for taxing parts of the same unitary group. In contrast, an
EC-wide group taxation system will involve one group-level allocation of the tax base. Hence, any
change in a state’s entitlement will require a re-assessment of taxable shares across the group.
Even this practice is, however, bound to give rise to complexity, as it will require extensive coordination among the Member States’ tax authorities. The first step is to delineate the scope of competence assigned to the tax authorities of the Member State which carries out the audit. In this regard, a crucial issue of state sovereignty will have to be resolved. Indeed, a tax audit carried out by a foreign authority is an intervention in the taxing state’s fiscal jurisdiction. Thus, as part of the audit procedure, the parent company’s state will inevitably have to review the tax accounts of each group member. That is certain to lead to re-assessments of tax liability.

Apart from the sovereignty issues, there also are practical aspects in the above proposed scheme. Namely, audits normally involve a revision of the financial accounts and tax results of the group entities. That is very likely to create difficulty for the tax inspectors in the state of the parent company. It is true that the individual subsidiaries’ tax bases which produce the group base may be computed pursuant to common rules. However, financial reporting norms will remain disparate among the Member States. It seems, therefore, very possible that ongoing assistance will be required from domestic accountants in tackling the results of group subsidiaries. A sophisticated system of exchange of information, possibly coupled with schemes of ongoing cooperation among national tax authorities, appears a necessity. The prospect of a more active presence of the Member States in which group subsidiaries are liable to corporation tax may also be explored. For instance, they could be given the right to participate in the audit procedure – probably through sending a tax inspector.

This section does not include a discussion of how to deal with disputes possibly generated in the context of an audit. Detailed analysis on dispute resolution follows under Part C below.

There is an exception here in connection with EU-listed companies, as they are required to report using International Financial Reporting Standards (IFRS).
Part C: Dispute Resolution

An EC-wide group taxation system is a unique experiment without a precedent, being a blend of intergovernmental and market integration features.\(^{507}\) Considering that the Member States in principle retain full sovereignty in direct taxes, a tailor-made solution should be devised to preserve that. This is necessary indeed, since a dispute in one state has an immediate impact on the taxing entitlement of all other states eligible for part of the same group’s tax base.

A crucial element would be to give the states which host group subsidiaries certain rights in determining their tax share.\(^{508}\) Part of this would be to devise a scheme for the settlement of disputes between Member States. The set of EC Treaty provisions on the jurisdiction of the ECJ does not supply an adequate legal basis in that regard. Indeed, in disputes between Member States, arbitration or, possibly, a panel facility could provide positive results faster than a Court procedure.\(^{509}\) Most disputes are expected to concern either the share of the group tax base allocated to each eligible Member State or the entitlement to group membership. The former will in principle surface in the process of an audit or an objection to a tax assessment by the taxpayer.

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\(^{507}\) For a discussion of the principles relevant to this interaction, see Chapter 4, Part B.

\(^{508}\) This strikes a balance between the absolute sovereignty of veto and decision-making by qualified majority voting (QMV). In certain international organisations of intergovernmental structure, decision is made by consent. Examples here are the WTO and the UN General Assembly.

\(^{509}\) This is also the framework through which the WTO Dispute Settlement Understanding operates. Since it has been designed to solve disputes between sovereign states, its structure could be of some relevance to the EC initiatives. See generally: F Ortino and E-U Petersmann (eds), *The WTO Dispute Settlement System 1995-2003* (Kluwer Law International, the Hague 2004).
I. Unique Features in the EIM

A dispute settlement instrument for an EC-wide group taxation system should reflect the special features attached to such a system. Those mainly originate in the nature of the EIM, which should respect state sovereignty in direct taxation, but also promote its objectives of market integration. It follows that the Member States should be granted standing, for the purpose of safeguarding their prerogatives. As example cannot directly be drawn from existing international practice, any scheme to be devised should be tailor-made to fit the structures and aims peculiar to the EC.

As said, disagreement is likely to arise in two main areas of an EC-wide group taxation scheme.

(i) The Definition of a Group (i.e. membership entitlement and territorial scope)

For purposes of administrative simplicity, provision should be made that groups become registered in the state of the parent company’s tax residence. Registration shall then be notified to the Tax Authorities of the group subsidiaries’ states. In such a context, standing should in principle be acknowledged to:

(i) the Member States, insofar as a state considers that an entity (-ies) resident in its territory should (or should not) have been incorporated in the group; and
(ii) the group, represented by the parent company, may challenge the decision on its composition.

(ii) The Computation of each Member State’s Share

Dividing the tax base by FA requires the creation of a mechanism for the purpose of allocating income to the eligible Member States. In an EC-wide scheme, common

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510 See the Introduction to this thesis.
511 Staff Paper 28.
512 It should be clarified that this proposal is limited to entity registration and is not meant to be a comprehensive ‘one-stop-shop’ scheme.
rules for allocation of the tax base should apply - at least - within each single group.\textsuperscript{513} In such a context, disagreements among the Member States, entitled to tax part of the group base, are inevitable. This is because the allocation of taxable profit is carried out, for the entire group, by the state of the parent entity's residence. As a result, states have to collect tax on the basis of a computation performed by another jurisdiction.

The question is whether the Member States will be given the possibility to raise objections to the taxable share assigned to them. It would be a significant limitation of their sovereignty not to be allowed to communicate their disagreement. Consequently, a standing to challenge the allocation of the group tax base should be given to:\textsuperscript{514}

(i) the Member States; and

(ii) the group, represented by the parent company.

These two categories of standing will be discussed below.

II. Disputes between Member States

Reasons of administrative simplicity and effectiveness require that disputes between the Member States be treated through a special settlement procedure. The aim should be to allow a solution to be reached within a short time. That often means outside the ordinary court procedure. Thus, a long judicial process would create considerable complexity. For instance, addressing tax assessments to group

\textsuperscript{513} See Chapter 7, Part B, Section I.

\textsuperscript{514} The standing recognised under the scheme demonstrates the dual nature of the mechanism for allocating the tax base within the group. On the one hand, the taxpayer should be given standing to challenge the assessment. The group is here in the position of taxpayer. This is the aspect of the system which highlights integration and aims at creating a fully-fledged scheme. On the other hand, the standing granted to the Member States accommodates an intergovernmental dimension which points to state sovereignty.
members, whilst disagreement is still pending on the apportionment, would foster legal uncertainty. Still though, the ECJ, as an institutional framework, should not be rejected, since it is always possible to set up a fast-track process within its ambit. Alternative procedures of dispute resolution, such as direct negotiation or arbitration, do not guarantee a quick completion either - unless appropriate rules are in place.\textsuperscript{515}

\textit{(a) Common Rules for Legal Certainty}\textsuperscript{516}

A certain practice should be established to secure a deemed consent by the Member States to the definition of a group or the allocation of the tax base. To implement such a system, a deadline for Member States' complaints should be set by a future EC Directive on group taxation. Once the deadline expires, provided no complaint has been filed, the act which determines the members of a certain group or allocates the profit will be deemed final. Such a scheme would allow Member States' sovereignty in direct taxation to survive. Thus, they would be granted a substantial right to oppose the result of acts performed by one state for the entire group. At the same time, the scheme would fulfil the requirement for legal certainty, since the taxpayer group would be given a clear and final picture of its tax liability.

If the Member States are deprived of the right to challenge decisions of the parent company’s state, the system will be faced with insurmountable complexities. For instance, a severe restriction of state sovereignty would occur if the Member States were under the obligation to collect amounts of tax they probably disagreed with. Further, taxpayers assessed to corporation tax would be likely to endure a situation

\textsuperscript{515} For example, see the MAP and the Arbitration Convention which both have failed to solve disputes in short time: OECD (ed), \textit{Improving the Resolution of Tax Treaty Disputes} (OECD, Paris Feb 2007) (hereinafter OECD Report for Revised MAP); Convention (EEC) 90/436 of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises – Final Act – Joint Declarations – Unilateral Declarations [1990] OJ L225 (hereinafter Arbitration Convention).

\textsuperscript{516} On legal certainty as a general principle of EU Law, see generally: P Craig, \textit{EU Administrative Law} (Oxford University Press, 2006) 607-654 (hereinafter Craig).
of legal uncertainty created by the possibility of a new tax assessment. More specifically, supposing that the Member States were given standing to bring an action against their allocated share following tax collection, the decision could potentially increase their taxable share. This would result in the taxpayer bearing *ex post* a supplementary tax liability. Such treatment of a taxpayer is clearly a failure to observe the principle of legal certainty. No grounds for estoppel are in issue here.

(b) Resolution of Disputes through Ordinary Court Procedure

The EC Treaty provisions on the jurisdiction of the ECJ allow for infringement proceedings to be initiated between Member States (TEC arts 227, 228). In this context, there is a Commission engagement in the pre-judicial process. It includes submission of ‘observations’ by the Member States involved as well as the issuance of a ‘reasoned opinion’ by the Commission. The process can obviously end up being rather long. Further, since the initiation of infringement proceedings depends on the discretion of the Commission, there cannot be any legal certainty that action will actually be taken at the end.

In addition to the above, it seems that an important drawback of using TEC art 227 is also the political ill-will which it witnesses. This is evidenced by the fact that the provision has so far been the legal basis for infringement proceedings in a very limited number of cases. Further, in most instances, the Member State which brought the action had support from either the Commission or other Member States.

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517 Romano 332.
518 Ibid.
519 Ibid 325-326.
520 TEC art 227 subparas 2 & 3.
522 Case 141/78 France v UK [1979] ECR 2923.
It follows that:

(i) It is very doubtful whether TEC art 227 can provide a legal basis, so that disputes between Member States can be brought before the ECJ;

(ii) A flexible structure in the form of a committee or panel should normally allow faster and more effective problem-solving. It has to be supported by an appropriate set of Rules of Procedure, which could still operate in the context of the ECJ.524

(iii) Dispute settlement between the Member States could take the form of: either a special procedure within the ECJ, possibly acting as an arbitration court,525 or a committee/panel staffed with Commission officials and national experts.

(c) Settlement of Disputes through Negotiation and Arbitration

The principal aim, as to the settlement of disputes between Member States, should be to create an effective system allowing deals to be reached within months. Ordinary judicial procedure at the usual ECJ pace would generate considerable complexity. This would therefore be an inappropriate path for resolving disputes among the Member States. Further, considering that state sovereignty in direct taxation should be retained526 a stage of negotiation between tax authorities, aiming at mutual agreement, appears a workable option.

Negotiation targeting at reaching mutual agreement is not an unknown process to Member States’ administrations. Article 25 of the OECD Model Double Taxation Convention (DTC)527 provides for negotiation, aiming at mutual agreement, between tax administrations where there are claims of incorrect application of the respective

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524 TEC arts 220 subpara 2 & 225A set out the framework for the establishment of judicial panels. The European Civil Service Tribunal which took up its tasks in 2005 was founded under the same provisions. The above legal basis provided by the EC Treaty could possibly be used in creating a panel to accommodate group taxation disputes between Member States.

525 The arbitration clause of TEC art 239 could provide a legal framework to this.

526 Staff Paper 371-372 (Title 12.2).

DTC. The OECD Model may give some useful ideas on the generalities of how to schedule a scheme for negotiation in the context of disputes on EC group taxation. However, the procedure attached to it suffers fundamental defects. In particular, its effectiveness is seriously undermined by the fact that the process may last for years. On the contrary, this work sets forth, as a priority, that Member State disagreements should be solved under fast procedures. That is vital to a smooth operation of the EC group taxation system. In addition, the Mutual Agreement under the OECD Model DTC contains no guarantee that a solution will finally be worked out. This is also a critical deficiency of the system, which is further intensified since, unless provided by domestic law, states are under no obligation to suspend tax liability.

The Arbitration Convention illustrates the importance of giving safeguards that direct negotiation will finally lead to settlement. The Convention is so far binding upon fifteen (the 'old') Member States. It thus provides that an advisory commission shall undertake to deliver its opinion if two years of negotiation go by in

529 OECD Model DTC art 25(1): ‘... The case must be presented within three years from the first notification of the action resulting in taxation...’. See also the OECD Commentary 2005 art 25 para 17.

530 OECD Model DTC art 25(3): ‘The competent authorities ... shall endeavour to resolve ... any difficulties ...’. ‘[...] They may also consult together for the elimination of double taxation in cases not provided for in the Convention’, OECD Model DTC art 25(4): ‘The competent authorities ... may communicate with each other directly ...’. See also the OECD Commentary 2005 art 25 para 26; ‘[...] but as far as reaching mutual agreement through the procedure is concerned, the competent authorities are under a duty merely to use their best endeavours and not to achieve a result[...]’ and para 45: ‘[...] It must, however, be admitted that this provision is not yet entirely satisfactory from the taxpayer’s viewpoint. This is because the competent authorities are required only to seek a solution and are not obliged to find one [...]’.

531 Evidence to these defects is the updated version of art 25 of the OECD Model DTC, which has been added a paragraph 5 to provide for the opportunity ‘...to submit the resolution of a particular issue which is preventing agreement in the case’ to an arbitration process with binding effect. A condition is that the competent authorities have been unable to reach agreement on the issue for two years since the case was presented. It is stressed that ‘resolution continues to be reached through a mutual agreement procedure’. For more details, see: OECD Report for Revised MAP para 46 of Proposed Commentary on the OECD Model (new) art 25(5).

532 An effort is made at OECD level to improve this situation for the benefit of the taxpayer. See OECD Report for Revised MAP paras 31.4-31.6 of Proposed Commentary on the revised OECD Model art 25.

533 Arbitration Convention arts 6, 7 & 11 in conjunction with art 12; see also earlier in this thesis Chapter 2, Part B, Title (iii).
unfruitfulness.\textsuperscript{533} The advisory commission is under the obligation to act within six months.\textsuperscript{534} Further, the parties are given another six months to renegotiate a settlement.\textsuperscript{535} If there is no positive outcome, the commission’s opinion gains binding status vis-à-vis the parties in dispute.\textsuperscript{536} In an EC group taxation framework, the Arbitration Convention could not apply, since its scope is limited to tackling double taxation (in transfer pricing disputes). Apart from that, extending its ambit to cover group taxation does not appear an appropriate policy option. The Convention’s provisions do not meet the requirement for a fast-track procedure. More specifically, the matter could remain pending over a period of roughly six years in one of the best case-scenarios.\textsuperscript{537} If a Court procedure has already been activated, a further delay occurs, since the two-year term for negotiation shall be launched only after judgment of the final court of appeal has been issued.

In the context of EC group taxation, it could be considered to give the Member States a period to negotiate solutions directly. That should not exceed six months. Such an approach would act as a strong indication that state sovereignty in direct tax matters is retained and enhanced. It would further allow legal certainty, as tax assessments will not be left in a pending (non-final) status for long. The same applies to replacing direct negotiation by an alternative mechanism (possibly, arbitration) after the six-month period lapses. The aim should be to put forward a solution within the following half-a-year at the latest. The decision should be binding on the parties, except if they have already reached agreement on a different basis.

A question relevant to the above involves the composition and function of a possible arbitration body or panel. The ECJ appears to be a suitable institution to accommodate arbitration. However, in such a case, special procedural rules should

\textsuperscript{533} ibid art 7 para 1.
\textsuperscript{534} ibid art 11 para 1.
\textsuperscript{535} ibid art 12 para 1.
\textsuperscript{536} ibid art 12 para 2.
\textsuperscript{537} Arbitration Convention art 7 para 1 subpara 2: the case should not have been submitted to the judiciary.
be enacted, so that the cases referred can be resolved within six months. As already mentioned, submitting the disputes to the Court’s ordinary procedure would seriously compromise effectiveness.

The EC Treaty contains a possibly suitable legal basis on the jurisdiction of the Court. This is TEC art 239, which reads as follows: ‘The Court of Justice shall have jurisdiction in any dispute between Member States which relates to the subject matter of this Treaty if the dispute is submitted to it under a special agreement between the parties’.

The specific article has not extensively been interpreted by the literature. Competence under this article may naturally derive from international agreements among the Member States. A clause conferring jurisdiction on the ECJ is also a requirement. The agreement should have been concluded on the basis of an EC Treaty provision. An example has been the Convention on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters concluded under TEC art 293 fourth indent. In addition, the Austria-Germany DTC guarantees that each case giving rise to a Mutual Agreement Procedure is either resolved thereby or submitted to the ECJ. It is doubtful, though, whether DTC clauses would enhance efficiency under these circumstances. Initiatives at bilateral level should be welcome but coordinated action is also necessary if it is to devise a comprehensive regulatory framework.

539 No reference to TEC art 239 is made in any of the following leading textbooks in EC Constitutional Law: A Arnell, The European Union and its Court of Justice (2nd edn Oxford University Press, 2006); G De Búrca and JHH Weller (eds), The European Court of Justice (Oxford University Press, Oxford 2001); Craig; L Neville Brown and T Kennedy, The Court of Justice of the European Communities (5th edn Sweet & Maxwell, London 2000). For a short reference, see Craig & De Búrca 96.
540 In the event that any difficulties or doubts arising as to the interpretation or application of this Convention cannot be resolved by the competent authorities by mutual agreement within a period of three years from the date of commencement of the proceedings the States shall be
To the end of adjudicating under TEC art 239, the ECJ should be given jurisdiction by virtue of a special agreement binding on the parties. In the case of EC group taxation, the relevant Directives and Regulations will be supplemented by an agreement among the participant Member States. Further, the prerequisite of TEC art 239 that the dispute should relate to the subject-matter of the EC Treaty will also be fulfilled. Thus, direct tax measures are enacted under TEC art 94. An amendment should also be made to the Court’s Statute and the Rules of Procedure to add a faster process in dealing with Member States’ disputes in group taxation. The scheme could possibly take the form of panels. That could however prove more complicated than expected, as it would require that the Statute of the ECJ be amended. The procedure is laid down in a Protocol annexed to the EC Treaty and amendment requires a unanimous Council vote.\(^{541}\)

TEC art 239 could offer a suitable legal basis for submission of group taxation matters to a fast-track procedure within the institutional framework of the ECJ. The amount of required resources will depend on the numbers of cases to be referred, which should be left to be determined in practice.

III. Disputes between Taxpayers and Tax Authorities

A primary question is whether each group entity is treated as a single taxpayer or, alternatively, only the group as a whole is entitled to bring judicial actions. This is a matter of policy choice which additionally has an impact on audits. Thus, in the event that the group is treated as one single taxpayer, then audits are most likely to be allowed only to the parent company’s state.

\(^{541}\) TEC art 245.

\(^{541}\) TEC art 245.
The implications of such a decision appear significant. On the one hand, placing the group, as a whole, in the position of taxpayer is a bold move.\textsuperscript{542} It thus presupposes that the subsidiaries’ states waive a significant degree of their tax sovereignty. This is because they will have to rely almost entirely on the parent company’s state as regards their taxing entitlement. One often comes across such schemes in group taxation systems which involve filing of a single tax return.\textsuperscript{543} However, the above mainly concerns group entities resident within one single jurisdiction, which implies that the challenge of reconciling sovereign states is absent.

Allowing appeals by each group entity to be brought before the domestic courts under the respective national rules would relieve from impasses connected with sovereignty. Still though, that would give rise to fresh concerns. Namely, there would be a clear risk of administrative chaos, as adjustments to past tax assessments would definitely be required.

The situation would become unworkable with certainty. So, despite sovereignty restrictions, it seems that dispute settlement should take a centralised form. In light of this, there seems to be no other path but authorising the parent group company to deal with its national tax authorities on behalf of the entire group.\textsuperscript{544} A framework of administrative rules at EC-level would be required to regulate this.

\textit{Establishing Jurisdiction of National Courts}

The taxpayers’ judicial protection does not seem to put forward challenges which require special treatment. In principle, appeals will be brought before the national

\textsuperscript{542} This is so if one considers that, in most national group taxation schemes, the entities retain their integrity. See also later in the thesis at Chapter 7, Part A, Section I.

\textsuperscript{543} See Endres 350-351: Australia, the Netherlands and the USA; earlier in this chapter Part A, Section III.

\textsuperscript{544} In any case, it is the tax authorities of the parent entity’s state that undertake to compute the group tax base and apportion it to the eligible group members.
courts of the parent company’s state. The ECJ could have an involvement pursuant to its existing jurisdiction.\textsuperscript{545}

The judicial procedure would normally be linked to the type of legal instruments used at EC level to enact legislation in the field. Namely, within an EC group taxation scheme, it is expected that the harmonised/coordinated regime will be laid down by Directive. This should be coupled with a number of Regulations, intended to tackle specific issues relevant to implementation. That includes giving detailed information on apportionment, setting forth audit rules, arranging formalities attached to the exchange of information, etc.

Appeals for judicial review\textsuperscript{546} will be directed against acts of the domestic tax authorities, issued in implementation of EC legislation. According to the Treaties, Directives should be transposed into domestic law within the deadline mentioned in their text. If the deadline elapses in the absence of transposition, a Directive may still develop direct effect under specific conditions.\textsuperscript{547} Should those conditions be established, the Directive may directly be invoked before a domestic court. Further, Regulations become automatically part of national legal orders and develop a full direct effect as well as supremacy. This implies that they can, as such, be challenged before the courts. Considering the above, a common type of appeal is against domestic administrative acts issued on the basis of national legislation which implements EC Directives. More specifically, the ground for judicial review may involve an alleged flaw of: (i) an (often individually-addressed) administrative decision or (ii) the domestic legislation implementing EC law (on the basis of which the decision is issued).

\textit{A Taxpayer’s Standing to Appeal Directly to the ECJ

\textsuperscript{545} TEC arts 230 and 232 (legal review), 234 (preliminary ruling) and 288 (non-contractual EC liability) could be of relevance here.  
\textsuperscript{546} TEC arts 230 and 232.  
\textsuperscript{547} For details, see: Craig & de Búrca 204 et seq.}
It is a long-established function of the Court to interpret EC Law and examine the conformity of national rules to it. Therefore, no amendment to its jurisdiction is required, for the purpose of carrying out these tasks. The beaten path to follow, for the purpose of reaching the ECJ, will be to have a preliminary ruling referred by the national court.\(^{548}\) That would, most possibly, concern the interpretation and implementation of the provisions of a Directive/Regulation.

Further, it appears that taxpayer entities are given limited scope to directly bring an appeal for judicial review before the ECJ. The provision\(^{549}\) reads that standing to appeal to the ECJ is, in principle, granted to individual taxpayers where a Decision is addressed to them. It may also be that a Decision is in the form of a Regulation or that it is addressed to another person. Yet, it should then be ‘of direct and individual concern’ to the taxpayer company in issue.\(^{550}\)

Given the case law of the ECJ in interpreting an ‘individual ... concern’,\(^{551}\) taxpayers assessed to corporation tax do not sustain high chances in being successful before the Court. More specifically, the so-called _Plaumann_\(^{552}\) test, still valid in the majority of cases, finds that persons are individually concerned: ‘if that decision affects them by reason of certain attributes which are peculiar to them or by reason of circumstances in which they are differentiated from all other persons’. Considering that law at EC level is normally of a general nature, the chances are that taxpayers fail the _Plaumann_ test. It follows that the prospect for direct action by a taxpayer against an EU institution is small – if not minimal.

\(^{548}\) TEC art 234.

\(^{549}\) TEC art 230 subpara 4.

\(^{550}\) Ibid.

\(^{551}\) Craig 331 et seq.; Craig & de Búrca 482-518.
Part D: Re-Assessment of Tax Liability

It is an inevitable outcome of the structure of an EC-wide group taxation system that, once a member’s tax liability is re-assessed, all members should be subjected to re-assessment. This is because each group member is allocated a share of the group tax base. If, for any reason, a member’s tax assessment has to be amended ex post, this immediately implies that the entire group’s ‘pie’ will have to be re-allocated.

A re-assessment of tax liability may be required in any of the following cases:
(i) As a result of a tax audit, the amount of tax due by a group entity is usually subject to re-assessment. This is so, where the entity’s revenue (before consolidation) has to be re-adjusted to comply with the audit conclusions. That leads to a re-allocation of the group base;
(ii) A dispute between Member States which involved the computation of the group tax base or the outcome of the apportionment is settled and leads to a re-allocation of the taxable shares;
(iii) A national court of the parent entity’s state issues decision on a taxpayer’s appeal against an act of tax assessment by the domestic tax authorities.

It is an obvious conclusion that any EC group taxation system would be bound to face, annually, numerous instances leading to a re-assessment of tax liability. An obligation to re-calculate the taxable shares each time that a re-adjustment were approved would render the system unworkable. In fact, that would suffice to defeat the fundamental objective of effectiveness. A possible solution to this could be that the parent company’s state takes account of all re-adjustments at the end of each tax year. The balance (i.e. difference from what was assessed in the year under re-assessment) would be added to, or deducted from, the current year’s share. Such a

553 Staff Paper 27.
process could hopefully allow the system to operate at some speed and at a lower administrative cost.

Conclusion

The above discussion of how an EC group taxation system could be administered demonstrates that an entire new structure would need to be put in place.

In principle, compliance and enforcement, to the exception of audits, do not seem to bring forth difficulties which cannot be dealt with. In contrast, the audits and dispute resolution require that the Member States concede a significant share of their sovereignty to the state of the reporting entity. This is, by itself, a strong indication, if not proof, that a unanimous vote is not a foreseeable prospect under the current circumstances. Indeed, if one considers that most parent group entities will be based in the wealthier Member States, one can predict an emerging hostility from the small countries. If agreement is ever close to be reached, the small states will most probably ask for compensation as part of the deal.

There are critical elements of substance which make EC group taxation schemes a mid- to long-term prospect. Yet, a good number of those problems seem possible to tackle in some way. The administration of the system, though, gives rise to unprecedented challenges. The Member States could only have a chance to solve the upcoming problems if they possessed a strong will. However, this seems to be absent - at least to the general impression.

\[ ^{554}\text{TEC art 94}\]
6. ENTITLEMENT TO MEMBERSHIP OF THE
GROUP

Introduction

Determining the criteria for entitlement to participate in a group is a key question to be addressed in connection with an EC-wide group taxation system. Over the years, different experiences of states have created traditions of different approaches to the matter.

In taxation, the policy decision lies between the following two structures: (i) schemes defining a group on the basis of holding percentage, which may, in cases, be coupled with supplementary tests; and (ii) a system focusing on the unity of business activity (i.e. unitary taxation). The former roughly reflects group taxation tradition in Europe whereas the latter originates in the US and flourished in sub-national taxes.

Group taxation systems applicable across Europe have so far been limited to a domestic context. They namely display no cross-border dimension, with the exception of Denmark, Italy and partly, Austria and France. A key feature

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555 C Amby, 'Report on Group Taxation in Denmark' in IFA (ed), Cahiers de droit fiscal international vol 89b (Cahiers de droit fiscal international, IFA, 2004) 233, 244 et seq. (hereinafter Amby in IFA Cahiers).
557 Austria does not align the treatment of non-resident group subsidiaries with that of resident group members, in which a scheme of pooling is in force. It only allows foreign subsidiaries' losses (and not
of those schemes is that they are based, almost exclusively, on ownership requirements (i.e. shareholding) among the group entities. It is only few countries (i.e. the UK, Germany, Austria and Italy) which incorporate in their laws certain conditions of substance, such as management control and economic nexus.

On the other hand, under unitary taxation, taxable items are exclusively determined by reference to considerations of integrity of the business activity. The scheme is largely an outcome of requirements set by the US Constitution and, notably, the Commerce and Due Process Clauses. It evolved over the nineteenth and twentieth centuries in parallel to the economies of the US States.

In this chapter, an attempt will be made to reach a conclusion on the appropriate features of a group taxation system intended to include entities from across the EIM. To this end, analysis will be carried out on existing options, classified, for simplicity, into four categories. It should be noted that the options extend beyond taxation, as management control is widely employed in Company Law. Thus, the following approaches will be discussed in connection with entitlement to group membership: (i) holding percentage; (ii) control over management; (iii) unity of business activities; and (iv) VAT grouping. Part of the effort will consist of examining complexities likely to emerge under each of the above schemes in the context of the EIM. Finally, whatever solution is promoted, it is necessary that it remains compatible with income allocation through FA.

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profits) to be considered. See: I Brandstätter and others, Investment in Austria (KPMG, Vienna 2004) 39 et seq. (hereinafter KPMG Austria (2004)).

Bénéfice Consolidé allows cross-border consolidation and applies to a small number of French multinationals; it is awarded through administrative decision at ministerial level.

The Commerce and Due Process Clauses are discussed in detail in Chapter 3, Part C, Section II.
Part A: Systems of Entitlement to Group Membership

In the IFA Cahiers’ General Report 2004,560 which dealt with group taxation, a corporate group was given the following definition: ‘a group of business organisations connected through common control by way of shareholding and/or other financial and managerial relationships’. The definition is broad. It thus comprises rules which determine membership on the sole basis of shareholding as well as tests setting forth other financial or managerial relationships additionally or exclusively. The definition may, therefore, accommodate both shareholding as well as control over decision making, as criteria for membership.

I. Holding Percentage

(a) The Rule

The determination of group membership on the basis of holding percentage points to a straightforward rule. This is because the decision only involves consideration of objective criteria (i.e. percentage of participation in share capital). It is possibly for this reason that most national group taxation systems employ shareholding as their primary criterion for membership. Thus, provided that the requirement for a specific holding percentage is not coupled with any supplementary criterion of a subjective nature, it can lead to an immediate conclusion on entitlement. It should, though, be noted that an approach based on a holding percentage does not test group unity for

substance. Namely, the system does not accommodate elements that place requirements for substantive links among group members. That does not often allow the group to retain an adequate degree of unity. Substantive elements in defining a group may consist of a requirement for some integrity of business activity or for centrally-oriented decision making.

(b) National Systems in Europe

The majority of EC Member States have opted for group taxation systems created, almost exclusively, on the basis of ownership in the sense of shareholding percentage. In most cases, this test is not supplemented by any condition of substance. Holding percentages in force range between 50 percent (i.e. Germany, Austria and Italy) to full ownership (i.e. Danish Joint Taxation provides for 100 percent), with a good number of systems having set their requirements at roughly 90 percent and over.

As said, the above rules apply, with small differentiations, to most states. Yet, in an effort to offset some of the negative aspects inherent in shareholding, Italy, Germany, Austria and the UK have arranged that their rules are coupled with some additional requirements.

561 The following EC Member States maintain group taxation systems: Austria, Cyprus, Denmark, Finland, France, Germany, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Poland, Portugal, Slovenia, Spain, Sweden, the United Kingdom. The data was derived from Commission (EC), ‘Annex to the Communication on the Tax Treatment of Losses in Cross-Border Situations’ (Commission Staff Working Document) SEC (2006) 1690, 19 December 2006 (hereinafter Annex to COM(2006)824).

562 The data used is derived from a comparative study held, on behalf of IFA, in 2004 for the purpose of preparing volume 89b of Cahiers de droit fiscal international. The study involved fifteen out of then twenty five EC Member States: Austria, Belgium, the Czech Republic, Denmark, Finland, France, Germany, Hungary, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom. In addition, two EFTA States were considered: Norway (also party to the EEA Agreement) and Switzerland. Research done for this thesis’ purposes has also covered fundamental updates in the systems of the above listed states.

563 Among the countries included in the 2004 IFA study, the following fall within this category: Denmark, Finland, France, Luxembourg, the Netherlands, Norway (EEA State), Portugal, Sweden.
In the Italian group taxation system, enacted in 2004, non-voting shares are ignored in calculating holding percentages. This limits decision on qualification for group membership to those shareholdings which involve participation in decision making through voting at the General Meeting.\textsuperscript{564} What is more, a supplementary condition is set, according to which, in addition to a majority shareholding, group members should also hold rights to dividends exceeding 50 percent.\textsuperscript{565}

In Germany and Austria, the \textit{Organschaft} has always involved a considerable amount of additional substantive prerequisites which were found to have rendered the system difficult to operate. Since 2003, the legal framework of the German \textit{Organschaft} has been simplified.\textsuperscript{566} There is, namely, no more a need to consider whether there is financial or organisational integration among certain entities, for the purpose of qualifying for an \textit{Organschaft}. This requirement used to give rise to significant complexity, as it involved an amount of subjective thinking and therefore, did not provide an adequate degree of legal certainty.\textsuperscript{567} Holding the majority of voting rights in the group subsidiaries is currently the only condition applying in addition to shareholding. This adds an element of substance to the system, as it allows a consideration of control over the group subsidiaries' decision making, without depriving the structure of legal certainty.

Austria proceeded with more ground-breaking measures. It replaced the \textit{Organschaft} with a new system which has been in force since 1\textsuperscript{st} January 2005. It in principle allows the pooling of group profits and losses.\textsuperscript{568} As regards entitlement to group participation, except for the 50 percent shareholding, there is also a requirement for control over management, which means the majority of voting rights should be held by the parent entity.

\textsuperscript{564} Nobili & Lanza 564, 565.
\textsuperscript{565} ibid 565.
\textsuperscript{566} Graf Kerssenbrock 4.
\textsuperscript{567} ibid, Eckstein in IFA Cahiers 301.
\textsuperscript{568} KPMG Austria (2004) 39-40.
Group membership tests in the UK appear a lot more elaborate. Again, the starting line is a requirement for 75 percent holding in issued ‘ordinary share capital’. Apart from that, a number of additional tests apply. Those are meant to ensure that there is a substantial economic nexus among group members. More specifically, the parent entity, referred to as the ‘equity holder’, should hold a right to 75 percent of the profit available for distribution as well as an equal right to distributable assets on a notional winding up. Further, the so-called ‘stability test’ suggests that the parent entity should be in a position to demonstrate that decision making at the level of the subsidiary is in line with its wishes. There is no requirement for a minimum of voting rights in the subsidiary. In addition, anti-avoidance rules have been devised to prevent manipulation of the above tests.

It should also be mentioned that, in some systems, shareholding appears to be a valid test in areas other than taxation. In French company law, the definition of terms ‘subsidiary’ (filiale) and ‘participation’ (participation) is based on shareholding. More specifically, qualification as a subsidiary requires that the majority of capital is held by the parent. As regards participation, it places a test of holding ranging between 10 and 50 percent of the subsidiary’s share capital.

(c) Commentary

If group membership is determined solely on the basis of shareholding, no guarantee for strong links among group members can be given. Shareholding can be an easily applicable test, as it leaves no room for discretion to the tax authorities. The fact,

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569 IFA Cahiers’ General Report 2004:38; Rupal in IFA Cahiers 689.
570 Ibid: ‘...all shareholders other than fixed rate preference shareholders and lenders whose loans are not normal commercial loans’.
571 Ibid.
572 Ibid 692.
573 Ibid 690-692.
though, that it does not place any requirement for the existence of economic ties among group members could give rise to manipulation in cases. More specifically, entities may artificially be incorporated into, or excluded from, a certain group. In the event of incorporation, they may subsequently be removed from the group as soon as this can be made possible by the rules on registration.

A reason for artificial incorporation may be to make use of the rules on group taxation, for the purpose of relieving losses. Conversely, a certain entity may be removed from the group, through a disposal of shares, whilst it is an integral part of the business. This is usually done for income shifting purposes. Further, exit from the group may be accompanied by a transfer of residence.576 CFC provisions and other anti-avoidance measures could possibly contribute to discouraging such attempts.577

In an EC context, a pure ownership test does not, in principle, appear as the optimal solution to meet the challenges involved. Namely, to the extent that entities under common ownership are accommodated within the same group, without actually being components of the same business, economic reality is distorted.578 More specifically, if revenues from businesses with different profit margins were pooled together and then, apportioned, the outcome would not reflect the group’s economic situation.579 Unless there is a unitary element, the formula factors will not be weighted in accordance with their contribution to a specific business activity.580

577 Any measures taken should be given a shape that does not risk to be found in breach of discrimination/restriction. For the concept of ‘wholly artificial arrangements’, see Case C-196/04 Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v CIR [2006] ECR I-07995 paras 51, 55, 57, 61, 63 & 69.
580 The proposal of this thesis for the EIM is set out later in this chapter at Part B.
Further, a theoretic principle-oriented explanation could be that the FA is meant to provide solutions in allocating taxable income where, due to high economic integration, synergies and economies of scale and scope are involved in the system. Considering this, a link based solely on holding percentage does not presuppose so integrated an activity as to create synergies. In that sense, an ownership test alone does not justify the use of FA as a replacement of arm’s length separate accounting.

II. Control

(a) Introduction

Control is not one of the primary tests employed worldwide in defining a group for corporation tax purposes. As shown in Section I above, it is normally used as a supplement to shareholding. Control is, however, the dominating test for group entitlement in Company law. It has been thought appropriate to discuss the elements of a control test as an alternative for group membership, as it already has a presence in taxation. In particular, voting rights constitute one of the criteria, secondary to shareholding, applied by some EC Member States (i.e. Germany, Austria and the UK). Below, group entitlement, in the field of Company law, will be discussed by reference to three Member States: the UK, France and Germany. A choice was made of these jurisdictions, as their legal systems represent both the common and civil law world.

(b) The United Kingdom

In UK Company Law, control over a subsidiary is tested by virtue of objective criteria. Thus, it is required to hold a majority of the voting rights in the shareholders’ meeting. The same applies to the right to appoint or remove members of the Board of Directors assigned with the majority of voting rights at board meetings. More specifically, Section 736 of Companies Act 1985 (as amended by Section 144 CA 1989) provides that any of the following cases may qualify, for company law purposes, as a group of companies:

(i) the holding company holds a majority of the voting rights in the subsidiary; or
(ii) the holding company is a member of the subsidiary and has the right to appoint or remove a majority of the members of the subsidiary’s Board of Directors; or
(iii) the holding company is a member of the subsidiary and controls alone, pursuant to an agreement with other shareholders or members of the latter, a majority of the voting rights in the subsidiary.\(^{582}\)

Indirect holdings may also qualify for a group.

The UK has adopted a more extended definition of control in connection with the obligation to draw consolidated group accounts (i.e. Balance Sheet and Profit & Loss Account). Those rules have been laid down in implementation of the 7th EEC Directive\(^{583}\) and extend the concept of control to the following two cases:\(^{584}\)

(i) The parent company has a right to exercise a ‘dominant influence’ over an undertaking (the subsidiary) by virtue of provisions laid down in the undertaking’s Constitution (Articles of Association) or in a “control contract”, which should be permitted by the Constitution; and

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\(^{584}\) For a general coverage of the cases in which group accounts shall be filed, see Griffin.
(ii) The parent company has a ‘participating interest’, meaning a shareholding of minimum 20 percent in the undertaking's capital, and actually exercises dominant influence over it or there is unified management of both undertakings.

It was thought, however, that an extended definition of control, such as that introduced by the 7th Directive in the field of accounts, would create uncertainty if brought into company law. As a result, it was decided that the scope of the two additional cases above should be limited to the consolidation of accounts and financial disclosure.

Both these rules seem to involve tests for control which are not as straightforward as the ones laid down in company law. Giving binding guidelines to the subsidiary's directors, in principle, seems a clear test. However, in practice, many grey-area cases may come to the fore. In addition, a shareholding of 20 percent, irrespective of the fact that it is coupled with a test of dominance, appears a relatively low requirement. This is particularly so if compared to the holding percentages that dominate national group taxation systems.

It follows that the rationale differs between allowing the formation of a group in company law, on the one hand, and placing an obligation for consolidated accounts, on the other. The former apparently requires stronger links among group participants. The reason possibly derives from the assumption that decision making within a group often aims at promoting the group’s overall interests. In that context, a decision could even be to the detriment of individual group subsidiaries if it is still beneficial to the group. For instance, a parent entity may refuse to rescue a subsidiary which becomes insolvent, in spite of the group’s possession of adequate...

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585 For the criteria which specify 'dominant influence': schedule 10A para 4(3).
586 It should be noted that delineation of 'control' is more extensive under the 7th Directive not only due to the additional cases qualifying for a parent-subsidiary relation but also because any undertaking (and not just companies) may be a subsidiary (s258(2) CA 1985).
587 Gower and Davies 208.
588 Ibid 207.
589 Those range between 50 (Germany) and 100 percent (Denmark).
590 Gower and Davies 202-203.
funds.\(^{591}\) It is obvious that the above presumes very close ties among the group members. Otherwise, legal certainty and the companies’ limited liability would be seriously compromised.

\((c)\) France

In France, Company Law links control, almost exclusively, to voting rights.\(^ {592}\) However, the definition of a group appears to distinguish among three separate concepts, of which control is only one. Namely, there is reference to a ‘subsidiary’ (filiale), ‘participation’ (participation) and ‘control’ (contrôle).\(^ {593}\) As mentioned earlier under Section I on the shareholding percentage, the tests employed to define the filiale and participation are exclusively attached to shareholding. Contrôle is, though, treated under more substantive terms (i.e. voting rights). Further, the French code commercial contains two separate sets of rules for company law\(^ {594}\) and consolidated accounts\(^ {595}\) respectively. In both cases, the underlying concept of the tests is the parent’s ‘control’ over the subsidiary.

Under Company Law,\(^ {596}\) control exists under any of the following circumstances:

(i) The parent possesses, directly or indirectly, such a percentage of capital in the subsidiary that it is allowed to hold the majority of voting rights in the shareholders’ meetings; or

(ii) The parent has the right to exercise a majority of the voting rights in the subsidiary pursuant to an agreement concluded with other members or shareholders and which is not contrary to the interests of the company; or

\(^{591}\) ibid 203.


\(^{593}\) Ibid.

\(^{594}\) Ibid.

\(^{595}\) ibid at 822: Code commercial art L. 233-16.

\(^{596}\) ibid 804: Code commercial art L. 233-3; LeGall and Morel 241.
(iii) Through the voting rights it holds, the parent, in fact, determines decisions reached in the shareholders’ meetings at subsidiary level.

In addition, control is deemed where the controlling company possesses 40 percent of voting rights in the subsidiary and no other member or shareholder holds, directly or indirectly, a higher percentage.

In relation to consolidated accounts, an obligation to comply with that formality arises if any of the following requirements\(^{597}\) is fulfilled:

(i) The parent company controls the subsidiary exclusively; this may involve (a) holding the majority of voting rights; or (b) the power to appoint the majority of members in the subsidiary’s management body for two consecutive fiscal years; or (c) the right to exercise a ‘dominant influence’ over the subsidiary under an agreement or clause in its statute, provided that the parent is a shareholder.

(ii) The parent company controls the subsidiary jointly with another company in such a manner that decision making is normally the outcome of their mutual agreement;

(iii) The parent company exercises a ‘notable influence’ over the subsidiary, which, pursuant to the law,\(^ {598}\) is deemed if the former holds, directly or indirectly, at least 20 percent of the voting rights in the latter.

French provisions on ‘control’ are, in principle, based on objective tests. Those do not normally leave significant space at the authorities’ discretion. Aiming at measuring influence on decision making, the tests primarily used are based on voting rights. It can be noted that, similarly to the UK, a group is more broadly defined in connection with the publication of consolidated accounts than under Company Law. This common approach may not have been fortuitous, as it is likely to have been the outcome of implementing the 7th Directive.

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\(^{597}\) Code des Sociétés 822: art L. 233-16; Le Gall and Morel 247.

\(^{598}\) Code des Sociétés 823: art L. 233-16 IV.
However, the regulatory framework is not in line with legal certainty at all times. More specifically, the domestic authorities are left with a considerable amount of discretion when called upon to interpret such concepts as ‘in fact determination’ of decisions or ‘dominant influence’. It is clear that the application of such factual contingencies needs to be supported by substantial tests on group unity. Considering this, the above concepts could potentially prove useful supplements to rules that contain primarily technical tests. They could thus reduce the risk of compromising substance.

(d) Germany

The striking feature about groups in German company law is the distinction drawn between optional groups (‘Vertragskonzerne’), created through a ‘control contract’ (‘Beherrschungsvertrag’), and actual/de facto dependence (‘faktische Konzerne’). Further, there is a closer form of optional association, referred to as ‘integration’ (‘Eingliederung’), which is only available to German public companies. It is beyond the scope of this work to go into detail in connection with each of these forms of group organisation. Rather, the focus will be on the criteria for entitlement to group membership and on their possible link to the aims which the groups have been established to attain.

An undertaking is ‘dependent’ if another undertaking is in a position to exercise, directly or indirectly, a dominating influence over the former. The controlling undertaking should have the means of making another (undertaking) comply with its wishes. At least one of the two undertakings should be a public company (‘Aktiengesellschaft’) or a company limited by shares (‘Kommanditgesellschaft auf Aktien’). There is a series of criteria which may be found to fulfil the meaning of

599 Wooldridge 48.
600 Ibid.
'dependence'. More specifically, the following could qualify for 'dependence':

(i) The existence of organisational and judicial instruments suitable to allow the exercise of specific influence on the (dependent) undertaking’s policy;

(ii) Pursuant to the (dependent) undertaking’s statute or articles of association, minority participations are granted with multiple voting rights which guarantee the majority of votes;

(iii) The dominant undertaking influences the exercise of control and inspection rights by silent members and lenders. That is particularly so where these have an impact on the overall policy of the dependent undertaking and its business direction.

According to Paragraph 18 AktG, which defines groups, it is presumed that a group is created between one or more dependent and one controlling undertaking. Further, ‘unified management’ is mentioned as a key element leading to the creation of a group, even in the absence of dependence. Legislation provides that the existence of ‘unified management’ is deemed within the context of optional groups. That is, namely, where there is a ‘control contract’ or ‘integration’. The Aktiengesetz’s provisions do not contain any definition of ‘unified management’. This is not a straightforward test, similar to those based on voting rights, which are employed under the UK and French systems. The concept of ‘unified management’ may take diverse forms. It could thus be any of the following:

(i) regular instructions;

(ii) treating the managers of the dependent undertakings as executive organs entrusted with the implementation of decisions reached by the dominant company;

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602 Wooldridge 48.
603 The cases listed are mentioned in Eisenhardt 487-488.
604 Aktiengesetz: (German) Stock Corporation Act; also see generally: H Schneider and M Heidenhain, The German Stock Corporation Act (CH Beck/Kluwer Law International, Munich 2000).
605 Eisenhardt 492.
606 ibid 493.
607 AktG para 18.
608 The cases listed are mentioned in Eisenhardt 493.
(iii) guidelines on fundamental matters relating to the dependent undertakings' policy and business directions as well as to the inspection of their compliance. Guidelines or advice do not need to necessarily take the form of instructions:

(iv) the persons in management do not need to be the same in both the dominant and dependent undertakings.

In ‘control contracts’ and ‘integration’, stronger ties are required between controlling and dependent undertakings.

More specifically, the instructions addressed to the dependent entities are binding and the policies pursued may even be to their detriment. It may be that the controlling company will have to indemnify the subsidiary for its annual losses but still, the type of relation calls for a higher degree of unity. Therefore, except for ‘unified management’, which is deemed to exist, the law also places supplementary requirements for establishment. Those additional points are objective in form, so that they can provide legal certainty.

In ‘control contracts’, a strict ownership-based test has been adopted. Namely, the conclusion of a contract should be approved by 75 percent of the capital represented in the votes cast at the shareholders’ meeting of the dependent undertaking. In addition to this vote requirement, if it is to create the so-called ‘integration’, the controlling company should also own a shareholding of minimum 95 percent in the dependent undertaking. Special provisions apply for compensating minority shareholders under this scheme.

It appears to be a rational policy decision to place stricter requirements where a dependent entity relies on the controlling company’s arrangements in connection with significant economic interests. However, the decision to switch to an ownership

609 Gower and Davies 204; Wooldridge 6.
610 Wooldridge 6; AktG para 293.
611 Wooldridge 7-8; AktG para 320.
612 AktG para 320b.
test, in cases of highly integrated groups, could possibly be challenged as an inappropriate route. Thus, if the policy objective is to achieve an increased amount of unity among group members, shareholding may not always be the ideal solution. This is because it is more of a technical, rather than a substantive test. By contrast, an amount of substance could have been retained in the system if the existence of ‘unified management’ had to be proved, instead of being deemed.

So, where there is the greatest degree of dependence under German Company Law, the groups are not primarily defined by reference to control. Instead, ownership seems to prevail. In ‘control contracts’, the requirements appear even lower than the conditions set for participation in group relief under the UK group taxation system. This is all the more so if one considers that a ‘control contract’ gives rise to more extensive intervention into the dependent entities than the UK intra-group transfers of losses in group taxation.

III. Unitary Taxation

(a) Introduction

A totally different approach to group definition is taken by unitary taxation. It involves a number of concepts developed for the purpose of computing corporation tax at sub-national level (i.e. State-level) in the US. Further, unitary taxation has so far inextricably been linked to tax base allocation through FA. In this context, the key underlying concept is the so-called ‘unitary business’, which roughly points to unity of commercial activity performed by the group as a whole.613

613 ‘...the linchpin of apportionality in the field of state income taxation is the unitary-business principle.’ W Hellerstein (1982) 158.

The discussion below does not aim at giving a thorough analysis of unitary taxation, as any such attempt would be beyond the scope of this thesis. The intention is to set out its key concepts and definitions, so that a discussion can follow on the suitability of a ‘unitary business’ definition for an EC group taxation system.

(b) The History

Unitary taxation is the outcome of the following two parameters: (i) The Commerce and Due Process Clauses of the US Constitution\footnote{The two concepts are discussed extensively in Chapter 3, Part C, Section II.} allow a US State to tax only such income or value of firms as earned within its border; and (ii) In mid-1800s, firms began to extend their activity across the frontier of single US States. In view of the above, the issue raised was how a firm would be taxed considering these constitutional constraints. More specifically, the US States are prohibited from taxing income of a corporation unless there is some minimum connection between the specific amount of income and the taxing State. In such a context, arm’s length was found not to lead to the true value of a tax base, as firms developed in integrated structures.\footnote{GN Carlson and H Galper, ‘water’s edge Versus Worldwide Unitary Combination’ in CE McLure Jr (ed), The State Corporation Income Tax: Issues in Worldwide Unitary Combination (Hoover Institution Press Stanford University, California 1984) 1, 5 (hereinafter Carlson & Galper); MJ McIntyre, ‘Contrasting Methodologies: A Systematic Presentation of the Differences between Arm’s-Length/Source-Rule System and a Combined-Reporting/Formulary-Apportionment System’ (1994) National Tax Association 226 (hereinafter McIntyre (1994)).} The majority of those cases concerned railroads and telegraph
businesses. The true value could only be computed if they were considered as one single ‘unit of assessment’. For instance, the value of railroads mainly consisted of the fact that they connected the East and the West. A calculation of taxable revenue on a source basis in certain loss-making States would disregard the fact that this State gains value from being part of the overall trip. Development in the area was carried forward by the jurisprudence of the US Supreme Court which elaborated on the Commerce and Due Process Clauses. The concept of 'nexus' emerged to allow the taxation of a share of the unitary revenues, even where no source could be established in the respective State.

(c) Divergent Definitions: Jurisprudence and Theory

Unitary taxation contains both technical and substantive tests. In addition to the requirement for control, a corporate group is defined by reference to substantive business criteria that broadly point to a unity of the business activity instead of the corporate structure it has been organised in. The key feature of the system is that it does not look at each entity separately. Neither does it distinguish between source- and residence-based rules, in order to determine the contours of a unitary group. Instead, the aim is to bring together the parts of a common business. This is done, regardless of the entity structures involved in the respective business and of possible territorial borders which delineate jurisdiction to tax. This is why a unitary group is, by nature, not limited to a specific geographical scope. Yet, most unitary

\[\textit{Advisory Commission on Intergovernmental Relations, ‘State Taxation of Multinational Corporations’ (1983) 18 Tax Notes 995, 999.}\]
\[\textit{Read generally: Fatale; Swain 372-373.}\]
US States have now conceded a ‘water’s edge’ election under severe international pressure.\textsuperscript{622}

There is no globally accepted definition of what constitutes a unitary business. There is, though, an amount of consistency in the principles attached to it over the years. Further, there is no uniformity in the details of tests applied by the Courts and put forward by literature.

After references by the US Supreme Court to the concept of a ‘unit of assessment’ in cases decided in 1875 and 1884 respectively,\textsuperscript{624} it was only in 1942\textsuperscript{625} that the Court first articulated a test for the so-called ‘unitary enterprise’. The test was based on the concepts of ‘...unity of use and management of a business which is scattered through several States...’.\textsuperscript{626} Further, the Court ruled that factors, such as functional integration, centralisation of management and economies of scale, arise from the business as a whole and there is no single identifiable source.\textsuperscript{627} The contribution or dependency test was put forward in Edison Stores.\textsuperscript{628} According to this, the requirements for a unitary business are fulfilled when the rule proves that ‘...the operation of a portion within the state contributes to, or is dependent upon, the operation without the state...’.\textsuperscript{629}
In 1980, the US Supreme Court decided *Mobil*.\textsuperscript{630} It found that the taxpayer did not submit adequate evidence to prove that the dividend payer companies were not part of the unitary business. Considering this, it was held that the State of Vermont was entitled to conclude that the dividends sourced outside that State did not destroy the nexus with in-state activities. In the same year, the Court ruled on *Exxon*.\textsuperscript{631} This is another case of which the facts were found to fulfill the unitary business definition. Gasoline sold by Exxon in Wisconsin was purchased through an exchange arrangement with Pure Oil Company. That allowed a saving on transportation costs. The Court established a unitary link between Wisconsin sales and the business of exploration, production and refining. It pointed out that, unless Exxon were engaged into the above activities, it would not have been in a position to enter into the exchange arrangement with Pure Oil. It was thought that this sufficed to bring Wisconsin revenues into the pool of the unitary business. The unitary business was referred to as the ‘*linchpin of apportionality*’.\textsuperscript{632}

In *ASARCO*\textsuperscript{633} and *Woolworth*,\textsuperscript{634} the existence of a unitary tie was rejected where income from intangibles arose from passive investment.\textsuperscript{635} A mere contribution to the corporate purpose was not found to suffice for sustaining the unitary link, as ‘*...income from whatever source always is a business advantage*...’\textsuperscript{636} This argument was developed further in *Allied-Signal*.\textsuperscript{637} More specifically, a distinction was drawn between an operational and an investment function of a capital transaction. A unitary business concept is sustainable only in the first case. Finally,

\textsuperscript{630} Mobil Oil corporation v Commissioner of Taxes of Vermont, 445 U.S. 425, 100 S.Ct. 1223 (1980) (hereinafter Mobil).
\textsuperscript{631} Exxon v Wisconsin Department of Revenue 447 U.S. 207, 100 S.Ct. 2109 (1980) (hereinafter Exxon).
\textsuperscript{632} Mobil 438.
\textsuperscript{634} F.W. Woolworth Co v Taxation and Revenue Department of New Mexico 102 S.Ct. 3128 (1982) (hereinafter Woolworth).
\textsuperscript{635} For a comment on the two cases, see: JM Greene, ‘*ASARCO and Woolworth: Anomalous Anachronisms with Limited Precedential Value*’ [1983] 18 Tax Notes 795.
\textsuperscript{636} Woolworth 363.
\textsuperscript{637} Allied-Signal Inc v Director, Division of Taxation 504 U.S. 768 (1992).
Container Corp\(^{638}\) set forth a set of criteria for unity: functional integration, substantial mutual interdependence and a flow of value.

It follows that there is no uniform and precise definition of the elements which allow qualification of certain activities as a unitary business. Divergent views have been put forward in the literature.

One of the tests marked as expansive\(^{639}\) is that of California which draws its origin from the railway ('unit rule') cases of the 19\(^{th}\) century. Ownership, operation and use are the three unities set forth to determine the existence of a unitary business. Those have been supplemented, through jurisprudence by the States’ courts, with dependency and contribution considerations.

Further, according to another approach, the requirements to be met, so that a number of affiliated companies can be treated as a unitary group, roughly boil down to three criteria: common control, interdependence (in the form of shared expenses, economies of scale or scope and intra-group transactions) and a substantial degree of dealings between the entities involved.\(^{640}\)

In the early 1980s, the definition of a unitary business gave rise to debate between two scholars (i.e. Hellerstein and McLure) regarding the utility of the so-called 'Basic Operations Interdependence Test'.\(^{641}\) In broad terms, the test, proposed by Hellerstein, involves flows of goods and services between controlled corporations. Only basic operations are included, which appears to comprise everything directly

\(^{639}\) JR Hellerstein, 'Allocation and Apportionment of Dividends and the Delination of the Unitary Business' [1982] 14 Tax Notes Today 155, 162 (hereinafter JR Hellerstein (1982)).
\(^{641}\) For a detailed analysis of arguments and the series of articles, by the two scholars, which discussed the issue, see: Special Reports The Unitary Tax Controversy: Articles and Commentary. Chapter V. Defining the Unitary Business [1986] 9 Tax Notes Today 153.
related to the business itself. Operations of support\(^\text{642}\) (such as accounting, legal, centralised advertising, etc) do not make part of the unitary enterprise. In addition, an amount of substantiality is a requirement. Otherwise, interdependence does not suffice by itself. According to Hellerstein, a controlled entity should qualify as substantially interdependent if its revenues from inter-company transactions amount to 15-33 percent of its operating gross receipts from basic operations.\(^\text{643}\) Criticism by McLure in this regard has mainly focused on the above theory's failure to address issues such as the role of management.\(^\text{644}\) Inevitably, since centralised management is not treated as an operation of interdependence, separate accounting is applicable. Such a situation fails to address a possible maximisation of profit due to the centralisation of management. Further, it would be likely to ignore factors which, over time, have been given significant weight in determining the existence of a unitary business.\(^\text{645}\) For instance, elements, such as common officers and directors, centralised bookkeeping or accounting functions and financial dealings, do not seem to qualify as 'basic operations'. This is indeed so if one considers that the inclusion of the above factors into the unitary business appears to be critical under the current multidivisional structures of conglomerates. Thus, in such a context, each of the functions set out above is, in principle, carried on through a separate legal entity.

The definition of a unitary business points to a subjective test. In light of this, it may be worth conceding to the view that there is no point in seeking to construe one single test for qualification. In this respect, Weissman's\(^\text{646}\) position appears a correct approach. According to this, it suffices to fulfil any one rule from a given list to qualify as a unitary business. These tests are mainly derived from key US Supreme Court jurisprudence in the field. The proposal comprises the four categories


\(^{643}\) JR Hellerstein (1982) 166.

\(^{644}\) McLure (1986a) 109.


\(^{646}\) ibid 267 et seq.
(d) Commentary

The concept of unitary business is intellectually challenging. Due to its substantive elements, it is by definition in a better position to fit into the objectives of an internal market, compared to ownership and control tests. On the other hand, despite being a suitable solution on a point of principle, a unitary definition can give rise to legal uncertainty and many difficulties in practice. This is because, as shown earlier in this Section, there is no generally acknowledged rule, or even set of rules, clarifying the criteria for group inclusion. Further, the fact that the crucial element is a specific business activity, rather than a legal entity, could generate unnecessary complications. In particular, identifying the various business fields in which a single entity may be active is a far from straightforward exercise.

Unitary taxation was created to fit the needs of the US market in its first steps towards integration. It then evolved in parallel to the US economy. It refers to situations of increased capital mobility in highly integrated markets where tax results of associated entities are marked by "synergism". As shown above, there is no single generally acceptable test for identifying a unitary business. Still though, despite implementation difficulties, this is by nature a more suitable path than residence

647 Ibid.
worldwide taxes when it comes to charging corporation tax at sub-federal level. This statement is usually justified on the following two grounds:

(i) Unitary taxation involves the use of substantive tests which appear more appropriate than technical rules for tackling tax avoidance practices;\(^\text{650}\) and

(ii) The allocation of profit by FA, which is normally attached to unitary groups, allows dealing effectively with transfer pricing complexities. In addition, it meets the needs of closely integrated markets.

More specifically, in connection with point (i), the use of substantive tests in delineating the group reduces the chances of manipulating the system. Normally, any income shifting to a sub-federal jurisdiction which applies tax at a lower rate should be accompanied by an actual move of commercial activity. However, when it comes to multinational groups, their intricate corporate structures may still allow income shifting without in parallel moving commercial activity. An example is to transfer loans and intellectual property rights to a sub-federal jurisdiction which applies a low tax rate. Indeed, intangibles can easily be moved around in the context of a multinational group. Still though, the above practice of tax avoidance could be deprived of a considerable amount of effectiveness if the group profit is allocated through FA. This is because the allocation factors function independently of where income is sourced.\(^\text{651}\) It therefore follows that unitary taxation (i.e. unitary business and FA) can contribute to preventing market distortion caused by income shifting in highly integrated markets.

Later in this chapter, under Part B, there is discussion of the suitability of a unitary group definition for the EIM.

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\(^{650}\) McIntyre (2004) 918.

\(^{651}\) FA may however also produce distortions; in the event that the formula employs firm-specific factors and different tax rates apply to each sub-federal unit, the overall tax burden of the unitary group may be decreased through factor-shifting: JM Weiner. 'Would Introducing Formula Apportionment in the European Union Be a Dream Come True or the EU’s Worst Nightmare?' (2002) 48 ifo Studien 519, 525 (hereinafter Weiner (2002a)).
IV. Value-Added Tax Grouping

VAT legislation contains rules for grouping. Article 4(4) of the Sixth Directive enables Member States to treat closely bound persons as a single person. This is only a discretionary clause; so, it is attached to no obligation. Fifteen Member States appear to have made use of the discretion given by the Sixth Directive and have introduced VAT grouping. Further, the Czech Republic, France, Latvia, Luxemburg and Poland are also reported to be considering the possibility of laying down rules.

Given that over half of the Member States apply VAT grouping, the rules for entitlement to group participation could be considered for an EC group taxation scheme. The nature of the rules in VAT grouping is determined by the Sixth Directive itself in Article 4(4). Namely, the precise national tests should in principle comply with the tripartite requirement of 'financial, economic and organizational links'.

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653 Subject to the consultations provided for in Article 29, each Member State may treat as a single taxable person persons established in the territory of the country who, while legally independent, are closely bound to one another by financial, economic and organizational links’ (Council Directive (EEC) 77/388 of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment [1977] OJ L145)

654 Austria, Belgium, Cyprus, Denmark, Estonia, Finland, Germany, Hungary, Ireland, Italy, the Netherlands, Romania, Spain, Sweden, the United Kingdom. Belgium passed the Bill to join only in November 2006 and the new law came into force on 1 April 2007.

The outcome is a rule which incorporates features of both ownership and control tests. More specifically, the condition of financial integration points to holding; that is, namely, ownership. The rates applied by the Member States range from beyond 50 percent of direct or indirect ownership in Germany to 100 percent in Denmark. The economic integration sets forth control considerations. In the Netherlands, the requirement is that the entities should serve the same type of clients. Austria sets forth a prerequisite for a reasonable interdependence in business/operations between the parent company and the others. It also points out that economic integration may exist when the entities are active in the same field of business as well as when the parent determines the business policy of the group. Finally, being under the direction of the same group of persons fulfils the organisational criterion in the Netherlands. In that regard, the German system requires that the will of the dominant entity can be enforced. In Austria, organisational integration means that there should be a minimum sharing of resources (e.g. staff) between the dominant entity and the subsidiaries.

The tests for entitlement to VAT grouping do not significantly differ from ownership-based national group taxation systems. Further, the additional elements of economic and organisational integration resonate with control tests in Company Law. In addition, some of the tests proposed by the OECD Model in connection

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657 Reiss, ‘Consumption Taxation and Financial Services in Germany’ in IFA (ed), Cahiers de droit fiscal international vol 88b (Cahiers de droit fiscal international, IFA, 2004) 371 (hereinafter Reiss).
658 Hansen and Jorgensen, ‘Consumption Taxation and Financial Services in Denmark’ in IFA (ed), Cahiers de droit fiscal international vol 88b (Cahiers de droit fiscal international, IFA, 2004) 292-293.
659 van Hilten, ‘Consumption Taxation and Financial Services in the Netherlands’ in IFA (ed), Cahiers de droit fiscal international vol 88b (Cahiers de droit fiscal international, IFA, 2004) 603 (hereinafter van Hilten).
660 Haunold, ‘Consumption Taxation and Financial Services in Austria’ in IFA (ed), Cahiers de droit fiscal international vol 88b (Cahiers de droit fiscal international, IFA, 2004) 163-164.
661 van Hilten 603.
662 Reiss 371.
663 Haunold 164.
664 See earlier in this chapter, Part A, Section II.
with the agency PE are similar to those of organisational integrity.\textsuperscript{665} All this evidences that VAT grouping does not put forward any novel criteria for entitlement to group membership. In addition, there is divergence in the way that the Member States have implemented the statutory language (i.e. Article 4(4) of Sixth Directive) on financial, economic and organisational integration. Thus, the tests may share the same ends but are far from being similar. In light of this, VAT grouping could not in principle provide a self-standing solution. It could however constitute a source of ideas in the context of the already identified areas of ownership or control.

Part B: A Choice for the EIM

Four existing systems for group definition were discussed in Part A. The analysis that follows is meant to identify tests for group definition which best suit the EIM objectives. This is intended to be done through a comparison of features inherent in the four systems and through examining their compatibility with broader taxation objectives and EC Law.

I. Interaction among Tests for Entitlement to Group Membership

Ownership and control approaches present some common features which draw a sharp distinction from unitary taxation. Similarity between the two systems mainly relates to both systems' technical nature. Further, the use of straightforward and objective criteria in delineating groups does not allow discretion to the tax

\textsuperscript{665} OECD Commentary art 5(5).
authorities, which enhances legal certainty. On the other hand, technically-oriented systems, such as the ownership- and control-based ones, do not guarantee a minimum unity of the commercial activities incorporated into a group. A unitary business occupies the other end of the spectrum. It may lack a generally applicable test, which inevitably creates uncertainty. Yet, unity of business activity is a prerequisite.

Unitary taxation in the US has largely been the outcome of the States’ efforts to retain their tax base while also complying with certain requirements of the US Constitution (i.e. the Commerce and Due Process Clauses). In the EC, the interpretation given by the ECJ to the fundamental freedoms has created tests for non-discrimination/non-restriction which point to a totally different perception from the US constitutional principles. The system in the EIM clearly reflects its strongly intergovernmental structure. Here, the Member States subject their residents to worldwide taxation. So, there is no need to establish a nexus to guarantee their taxing rights. The only restriction is set by non-discrimination/non-restriction considerations, as formulated by the ECJ. This however involves tests (mainly of comparison) which follow a totally different path from the prohibition of inter-state taxation laid down through the Commerce Clause.

To reach decision on a test for entitlement to group membership, options should be tested by reference to the main problems intended to be solved. As explained in Chapter 4, the Freedoms do not place a requirement for a specific choice of group taxation system. This is instead an initiative meant to build on broader (legally non-enforceable) objectives of the EC Treaty. The following are key identified fields:
(i) To offset group profits and losses;
(ii) To tackle transfer pricing formalities and, especially, the problems relating to the difficulty in drawing price comparables;

667 Chapter 1, Part A, Section II, Title (ii).
668 Staff Paper 223-305.
669 ibid 242 et seq. & 333-344.
(iii) To bring taxation closer to economic reality, which is marked by highly integrated market structures; that mainly concerns addressing tax-related issues which come to the fore as a result of market integration. Namely, taking account of synergism and economies of scale and scope allows consideration of flows of value among parts of MNEs which cannot be caught under an arm’s length entity-by-entity approach.\textsuperscript{671}

Allocation of the group tax base through FA is a prerequisite for fulfilment of both (ii) and (iii). Yet, item (iii) also requires a unitary definition of group, so that the requirement for business unity can be fulfilled.\textsuperscript{672} In addition, the FA contributes to materialising (i), which can still be achieved in a framework of arm’s length separate accounting.

It can be concluded from the above that the allocation of profit through a FA is a necessary element which should supplement any tests for entitlement to group membership. The FA is also present as the method for profit allocation across the group in both the CCCTB\textsuperscript{673} and HST proposals.\textsuperscript{674}

The long tradition of US state taxation clearly evidences the compatibility of unitary tests with FA.\textsuperscript{675} The question coming next is to what extent a non-unitary group scheme can be reconcilable with FA. Namely, if unity of business activity is absent, is it still possible to operate the FA? It all boils down to whether groups defined pursuant to ownership or control tests can be subjected to FA.

\textsuperscript{670} ibid 255 et seq. & 344-357.
\textsuperscript{671} Musgrave (1987) 197-198.
\textsuperscript{672} McLure (1984) 96-98.
\textsuperscript{673} Commission (EC), ‘An overview of the main issues that emerged at the second meeting of the subgroup on group taxation’ (Working Document) CCCTBWP/0048/doc, 23 November 2006 (hereinafter WG Doc 3 on Group Taxation); idem ‘An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB’ (Working Document) CCCTBWP/0052/doc, 27 February 2007.
\textsuperscript{674} HST (Lodin and Gammie) 24.
\textsuperscript{675} See earlier in this Chapter at Part A, Section III.
In principle, it cannot be excluded that FA be applied where participation is determined on the basis of a technical test (i.e. holding percentage or control) rather than by reference to business unity. Thus, if the economic reality were such that each entity carried on only one business, there would in fact be no need to distinguish between the two types of tests. However, separate consideration is required where one entity accommodates activities from more than one business area. In such a case, if a technical test is applied, distortion is bound to arise in allocating the tax base to the eligible group entities. Namely, the weight of each factor for FA, measured at the entity level, means that reference is made to a factor’s contribution to more than one business activity. Such a scheme does not provide any framework for a separate consideration of profitability in each business. Thus, factors, taken into account at entity level, are deemed to carry equal weight in connection with all business activities performed by the respective entity.

The outcome is that a technical test for group membership, if coupled with FA, suffers distortion. The FA is understood to provide a solution of increased accuracy in computing income within highly integrated businesses. Placing equal weight on activities with different profit margins does not contribute to accuracy. In particular, such distortion gives a tax advantage to entities which combine a significant part of high profitability and a small part of low-profit activity. This is because the tax liability corresponding to the highly profitable part will be mitigated (across the various businesses).

II. A Rule for Defining Group Membership in the EIM

The documents produced by the Working Group on the CCCTB contain discussion on a choice of test for entitlement to group membership. 677 The European Commission initially put forward legal and economic ownership as policy options open to the Member States for commentary and discussion. 678 This is a discussion of broader relevance, as it concerns any EC-wide group taxation scheme. Indeed, it is also a matter to deal with under HST. 679 In that introductory approach taken by the Commission, legal ownership touched upon shareholding. Further, the economic tests pointed to unitary taxation. No position was taken in favour of any of the two at that stage, even though tests based on holding seemed to be treated as a primary choice. Business unity, on the other hand, created the impression of being destined to rectify flawed aspects of shareholding. It could therefore be claimed that the Commission wished to encourage a scheme which combined features of both systems – probably, to a different extent. 680 Following a position in favour of a technical test comprising a single criterion (i.e. ownership or voting rights), 681 a further step was taken in the latest WG document. 682 It is namely reported that general agreement was achieved on a system for group membership based on control. So the test should be one of voting rights. 683

In light of the above, the choice between a system based on technical features and one based on substantive features should be discussed.

677 Commission (EC), ‘Issues related to group taxation’ (Working Document) CCCTBWP035\doc, 5 May 2006 (hereinafter WG Doc 1 on Group Taxation); idem ‘An overview of the main issues that emerged at the first meeting of the subgroup on group taxation’ (Working Document) CCCTBWP044\doc, 24 August 2006 (hereinafter WG Doc 2 on Group Taxation); idem WG Doc 3 on Group Taxation; idem ‘An overview of the main issues that emerged at the third meeting of the subgroup on group taxation’ (Working Document) CCCTBWP053\doc, 1 March 2007 (hereinafter WG Doc 4 on Group Taxation).

678 WG Doc 1 on Group Taxation para 15 et seq.

679 HST puts forward a proposal for a three-rule test which should be part of a HST Convention: (i) a minimum ownership or control requirement is set as a condition for participation in the Home State group; (ii) membership of only one Home State group will be allowed, which implies that the above minimum should be fixed at over 50 percent; and (iii) the parent entity's direct or indirect holding in a subsidiary should fulfil the domestic (i.e. Home State) requirements for entitlement to group membership. For details, see HST (Lodin and Gammie) 42-43.

680 WG Doc 1 on Group Taxation paras 15 & 27.

681 WG Doc 3 on Group Taxation para 5.

682 WG Doc 4 on Group Taxation.

683 ibid paras 13-14.
Unitary taxation, being a substantive test, can better fit the structures of an internal market. That may not prove functional in practice though. A reason may be that such a scheme points to concepts unknown to national group taxation systems applying across Europe.

Further, the amount of uncertainty involved in determining group membership, due to the plethora of applicable tests, could give rise to large numbers of disputes among Member States. This is indeed a likely prospect in view of the framework for decision on group membership. It is thus estimated that numerous disputes will come to the fore due to the fact that no central authority at EC level would hold the competence to determine group membership. Neither is there the possibility of a scheme, similar to that of the US States, in which each Member State would delineate the group pursuant to its own rules. Rather, the position seems to be that the decision will be delivered by the state of the parent entity each time.\footnote{684} In line with state sovereignty in direct taxation, this thesis suggests that all other eligible Member States should be vested with a right to object to the above decision on group determination.\footnote{685} It is obvious that giving power to more than one body increases the chances of a clash.

It follows from the above discussion that a technical system looks more likely to attract the Member States’ vote. That is apparent, having examined the implementation complexities to which unitary taxation may give rise.\footnote{686} Member States’ familiarity with ownership/control tests could also play a part in reaching a decision.\footnote{687} Further, it appears that certain drawbacks, such as vulnerability to tax abuse, can be tackled to a certain extent through the rules for FA and group registration.

\footnote{684}{In relation to the CCCTB, see generally WG Doc 2 on Admin Issues; in relation to HST: HST (Lodin and Gamme) 21 et seq.}
\footnote{685}{Chapter 5, Part A, Section I and Part C, Section II.}
\footnote{686}{See earlier in this chapter Part A, Section III, Title (d).}
Considering this, the tests of legal ownership and control should now be explored.

A first issue for clarification is whether a system of control could contain substantive – possibly, unitary - elements and also retain its technical structure. Indeed, control could possibly strike the proper balance between technical elements and substance. Control is normally specified through voting rights, a power to appoint members of the Board of Directors and the exercise of unified management over the group entities. A degree of unity which shareholding tests alone are not in a position to ensure can be demonstrated here. However, this is a management-related unity. As a result, it does not guarantee any unity of the business activity itself.

Control tests, being primarily used for company law purposes, do not seem to be a test more suitable than shareholding in the field of taxation. The reason is that the objectives to be safeguarded in taxes differ substantially from those given priority in company law. More specifically, providing security to lenders, protecting minority rights, ensuring that directors bear liability for their acts, constitute key items in connection with which company law should provide solutions. Control over an entity’s decision-making appears to be a prerequisite for performing these functions. On the other hand, different aspects in a company’s life bear weight when it comes to taxation. In this respect, the decisive element is profit. Profit roughly coincides with the tax base. Therefore, the system aims at using tests which contribute to a fair allocation of tax base (i.e. taxable profit). Ownership, in the form of shareholding, is naturally the decisive factor in determining entitlement to distributed profit. Further, supplementary tests, such as rights to dividends or rights

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687 Eighteen Member States operate group taxation systems. All schemes are structured on the basis of holding percentage and some of them also contain features of control tests: see at Annex to COM(2006)824.

688 See generally Gower and Davies; Griffin.

upon winding up, currently part of the UK system, allow a more comprehensive structure.

Therefore, if decision is reached for a technical criterion, there does not seem to be a reason for adopting a more elaborate test than holding percentage. The latter could also be coupled with supplementary tests, for the purpose of adding more substance to the system and discouraging tax avoidance schemes. More specifically, the following features will have to be explored:

(i) **Determining Holding Percentage for Group Membership**

One issue to be discussed is which rate the holding percentage should be fixed at. The rates appearing on the Parent-Subsidiary and Interest & Royalties Directives are most probably too low for a group taxation system. Thus, the vast majority of shareholdings in national group taxation systems range between 75 and 100 percent. This constitutes a strong indication that rates should be fixed at levels higher than those of the above Directives.

(ii) **Supplementary Tests**

Group membership tests fixed by reference to ownership (i.e. holding percentage) may provide a straightforward solution. These tests are practical to use at a first stage of consideration. Still though, they should be supplemented by additional factors, so that tax avoidance risks, to which holding tests are prone, can be reduced.

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690 See earlier in this chapter Part A, Section I, Title (b) on the UK system.
691 P-S Directive art 3(2); I & R Directive art 3(b).
692 For more details, see earlier in this chapter Part A, Section I, Title (b).
Given the diversity in anti-avoidance tests applying at the national level across Europe, a European General Anti-Avoidance Clause\(^{693}\) would probably add to complexity. The Member States would be called upon to agree on an additional set of common rules. In light of this, it may be better to lay down specific anti-avoidance provisions intended to deal with identified areas of risk.

A test would probably be required for the purpose of combating the artificial incorporation of business activities into a group. A system of monitoring may be put in place to be performed by each subsidiary’s Member State. In that context, transfers of business into group entities, shortly\(^{694}\) before or after their registration as members of the group, should be tested for their commercial purpose. Transfers to be identified as possibly suspicious should involve activities clearly unrelated to the group’s main business. It is also crucial that the business fields in which a group engages should demonstrate a degree of coherence.\(^{695}\) Otherwise the result of allocating the group tax base by FA will be significantly distorted and prone to manipulation. The taxpayer may bear the onus of providing adequate evidence that any new activity in the group has not been brought in with a view to avoid taxes. In this respect, some common rules should be devised, giving the national authorities’ guidelines on how to establish the existence of tax avoidance arrangements.

In cases of activities being closely tied to the main group business, tax avoidance may consist of transferring branches of activity to entities outside the group.\(^{696}\) In this regard, national CFC rules could possibly be a solution – at least, for the midterm.

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\(^{694}\) Possibly, some indication of time could be given. That could, for instance, be three months. However, this should not take the form of a binding rule; instead, room should be left for consideration of individual facts by the tax authorities.

\(^{695}\) Weiner (1999) 76, 77.

\(^{696}\) At least, this normally involves a genuine transfer of activity. In addition, the possibility of setting up a separate subsidiary for the purpose of reducing the tax liability is not effective under a scheme of FA: McIntyre (2004) 918; Weiner (1999) para 32.
Another area in which tax avoidance practices may flourish relates to transfers of holdings, aiming at artificially adding or removing entities from the group.

The CCCTB working party has set forth the idea of an ‘ownership averaging method’. That is, the ownership of voting rights is decided by reference to the state of affairs at the beginning and at closing of the tax period. A counter-argument is that abusive behaviour could enter into arrangements to comply with the ‘averaging rule’ at the two specified points in time while defying compliance over the remaining course.

Those cases may be dealt with through placing a requirement for retaining holdings in a group entity over a minimum period. Namely, provision could be made for a minimum holding of five years, which should apply on an entity-by-entity basis. Such a scheme could combat tax avoidance to a considerable extent. It would render it difficult to manipulate group composition, through artificial ‘entries’ and ‘exits’, as each entity should remain a group member for five years. Otherwise (i.e. in the event of an early leave), the beneficial effects of group taxation should be reversed ex tunc. In support of the above, it may also be noted that discretion to lay down a minimum holding period of two uninterrupted years is given to the Member States in the Parent-Subsidiary Directive.

It has been explained earlier that, in principle, this thesis is not meant to cover the aspects of an EC group taxation scheme which relate to tax abuse. The above discussion is only some preliminary thinking on issues specifically related to the entitlement to group membership. The aim primarily is to highlight that holding tests cannot guarantee an efficient solution on their own.

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697 WG Doc 4 on Group Taxation para 15.
698 Chapter 5, Part A, Section I, Title Term of the Group.
Conclusion

The analysis carried out in this chapter went through the main systems applying internationally in connection with group membership determination. It seems that, despite its drawbacks, a test fixed by reference to holding percentage is the optimal choice for the EIM. Thus, the concept of a unitary business, albeit theoretically appealing, does not appear compatible with the current state of integration in the field of direct tax. Further, control, as determined through voting rights, serves better certain aims attached to Company Law.

It has been noted that a scheme of shareholding contains features prone to manipulation leading to tax avoidance. It is, however, true that the severity of their impact can be attenuated through adding supplementary tests. Further examination, specifically oriented towards tackling tax abuse, is required to the end of arriving at proposals. It is also obvious that these matters can only be thoroughly explored after decision has been finalised on the main structural elements of the scheme.

In later chapters, there is examination of all other key elements of an EC-wide group taxation system. The conclusions reached here will be considered in conjunction with the points set forth there.

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609 P-S Directive art 3(2).
7. THE GROUP TAX BASE

Introduction

A decision on the structure of the group tax base in a system which applies across more than one jurisdiction brings forth a number of complexities. In the framework of the EIM, each Member State applies a fully-fledged corporation tax system which has been in force for years. As a result, there are significant disparities which cause incoherence. In light of this, a number of questions are raised: (i) Which methods of tax base integration should feature in a specific model for group taxation? (ii) Should there be a harmonised base and rates or could a scheme remain functional in a landscape of diversity? and (iii) Which elements of income should be part of the group tax base?

This chapter will be divided in three parts (i.e. Part A, B and C) corresponding to points (i) to (iii) above.

In Part A, an attempt will be made to clarify the concepts attached to tax base integration with a special focus on ‘consolidation’ and ‘pooling’. It will be shown that pooling is a broader term than consolidation but, for the purposes of EC group taxation, the terms may be used interchangeably. In that context, the interrelation

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701 The term ‘tax equalisation’ is used by B Wiman and has been defined as ‘the levelling of the tax burden with respect to the operating profits and losses of two or more companies’. The author mentions that this term is meant to cover all diverse models for achieving the intended tax result. For more details: B Wiman, ‘Equalizing the Income Tax Burden in a Group of Companies’ (2000) 28 Intertax 352 et seq. (hereinafter Wiman (2000)).
between the group tax base and allocation systems will be examined. Emphasis will be given to whether consolidation/pooling\textsuperscript{702} should be treated as a prerequisite for FA.

Harmonisation matters will be explored under Part B. The analysis will assess two separate procedural stages. That is namely the computation of each entity’s tax base followed by creation of the entire group’s tax base. In addition, the prospect of creating uniformity will be discussed in the light of two options: harmonisation of the tax base or of the rates.

Finally, elements of the tax base, inherent in group taxation, will be discussed in Part C. Two areas will be covered: intra-group and inbound payments. In this field, the examples relevant to sub-federal corporate taxation will have to be limited to the US. The reason is that the other two comparators (i.e. Canada and Switzerland) do not accommodate group taxation. As a result, the concept of a group tax base is unknown in those systems.

**Part A: Models of Tax Base Integration**

The term 'consolidation' is used in the documents of the European institutions to describe the method for calculating the tax base in the proposed group taxation schemes.\textsuperscript{703} In an EC context, consolidation involves an aggregation of group members’ individual tax bases, calculated separately, according to common rules

\textsuperscript{702}At this stage, both terms are still used interchangeably, as, in the author’s view, the meaning which they have taken on different occasions has created an amount of confusion as to their content. Discussion will follow in Part A to delineate the concept of consolidation and draw the distinction, if any, from pooling. In particular, a commentary will be included on the use of the term ‘consolidation’ in the context of the EC group taxation proposals.

applicable across the group.\textsuperscript{704} However, the use of the concept ‘consolidation’ in international tax literature seems to give rise to some ambiguity regarding its constituent elements.

The discussion below will focus on clarifying the concepts of the main schemes applicable worldwide to group tax base computation. To this end, examples will be derived from group taxation systems applying to EC Member States and internationally. In that context, an attempt will be made to identify divergent approaches to the term ‘consolidation’. In addition, the interaction between consolidation and FA is analysed as part of a separate section. A key matter for discussion touches upon whether consolidation is a prerequisite for FA. Related issues, such as the compatibility of consolidation with separate accounting, will also be explored.

I. Clarification of Terms: consolidation, pooling, loss transfer, (profit) contribution

The above terms point to the four main categories of group taxation which one comes across in the national systems of EC Member States. The primary feature of both ‘loss relief’ and ‘profit contribution’ is that neither of them involves the creation of a single group tax base.\textsuperscript{705} In that sense, they are clearly distinguishable concepts from ‘consolidation’ and ‘pooling’. In the case of loss relief,\textsuperscript{706} losses are surrendered from a loss-incurring group member to a profit-making one. Group

\textsuperscript{704} For the CCCTB, see WG Doc I on Group Taxation paras 11-14 fn 2. For HST, see HST (Lohin and Gammie) 32.

\textsuperscript{705} In systems of loss relief, there is a transfer of losses from one group entity to another. This is done on a bilateral basis. Profit contribution operates on the same principle but consists of transfers of profit.

\textsuperscript{706} National group taxation systems in Europe which accommodate loss relief are: Cyprus, Ireland, Latvia, Malta and the United Kingdom. For details, see: WG Doc I on Group Taxation paras 11-14 & 29.
entities retain their individuality. Integration is limited to surrendering or considering losses on an entity-by-entity basis. Profit contribution schemes lay down similar structures. They are aimed at mitigating the tax liability of profitable group entities through transferring parts of their tax base to loss-making affiliates.

The distinction is more difficult to draw between consolidation and pooling. In both cases, the end result is that a group tax base is created. The creation of a single group tax base, in all cases, allows profits and losses of individual group members to be set off against one another. Other benefits, such as tax-free intra-group asset transfers are also common occurrences. It appears that the literature makes use of the term ‘consolidation’ to describe schemes involving different degrees of integration. Still though, it can be identified that consolidation accommodates two broad categories of group taxation systems.

More specifically, there are few structures of very close integration in which the group is treated as a single unit/entity. Examples of such systems, also referred to as ‘full consolidation’, are Australia and the Netherlands. Under the Australian system, assets, liabilities, actions and events related to the subsidiary are attributed to a single fiscal income statement to the parent group company. In the Netherlands, a single fiscal income statement (i.e. one collective Balance Sheet) should be prepared for the group, aggregating assets and liabilities of the entities forming the fiscal unity. Under both the above schemes, intra-group transactions are always eliminated and one single tax return is

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708 Profit contribution is the group taxation scheme of the Scandinavian countries; in the EU, it is applicable in Finland and Sweden.
709 Staff Paper 372.
710 Endres 351; Wiman (2000) 353-354; WG Doc 1 on Group Taxation para 14 fn 2.
filed by the parent on behalf of the entire group. Further, liability to pay taxes clearly
rests with the head company of the group exclusively.\textsuperscript{713}

The second category of group taxation systems\textsuperscript{714} falling within the scope of
'consolidation' is the most popular among states.\textsuperscript{715} This is also often referred to as
'pooling'.\textsuperscript{716} In France,\textsuperscript{717} one of the states in which such a scheme applies, liability
to pay the tax on behalf of the entire group is exclusively borne by the parent. The
legislation in force does not stipulate how the amount of tax due should be allocated
to the group members. This is determined by contract signed by the group entities.\textsuperscript{718}
Finally, intra-group transactions are eliminated only when it comes to fixed assets. A
similar scheme is in force in Germany (\textit{Organschaft}).\textsuperscript{719} However, ties among
the group members are looser, as intra-group transactions are retained. All the more so,
each group entity remains liable to pay the tax it has initially been assessed to. Under
the Danish \textit{Joint Taxation},\textsuperscript{720} the group is taxed to the consolidated 'joint taxable'
income but all companies have a collective liability to the state for corporation tax. It
should be noted that, albeit the existence of close inter-company ties, intra-group
transactions are still recognised. In connection with return filing, the vast majority of
systems provide that each group entity is encumbered with carrying out the
formalities of its own tax return filing.\textsuperscript{721} An exception is the US regime,\textsuperscript{722} which is
marked by the single consolidated return scheme. This is submitted by the parent
company for the entire group. As regards liability to tax, no uniformity of treatment
can be identified. For instance, each group subsidiary remains liable to tax in
Germany\textsuperscript{723} and collective liability is the case in Denmark.\textsuperscript{724} In the US\textsuperscript{725} and

\textsuperscript{713}ibid; O'Donnel and Spence in IFA Cahiers 126-127.
\textsuperscript{714}Endres 351; Wiman (2000) 353.
\textsuperscript{715}Information is derived from the data presented in Endres 350-351.
\textsuperscript{716}See tables in Endres 350-351; KPMG Austria (2004) 39.
\textsuperscript{717}Borrat and Bassière in IFA Cahiers 277.
\textsuperscript{718}Ibid.
\textsuperscript{719}Eckstein in IFA Cahiers 304-305.
\textsuperscript{720}Amby in IFA Cahiers 241.
\textsuperscript{721}Among the countries surveyed by Endres, each group entity files its own tax return in Austria,
Denmark, France, Germany, Luxembourg, Spain, Sweden and the UK. Return filing is carried out by
the parent in Australia, the Netherlands and the USA. See Endres 350-351.
\textsuperscript{722}Sparagna in IFA Cahiers 715 et seq.
\textsuperscript{723}Eckstein in IFA Cahiers 304-305.
Spain, consolidated members are jointly and severally liable for the group tax liability. By contrast, liability is limited to the parent in France, notwithstanding the fact that the scheme is not one of full consolidation.

Use of the term ‘pooling’ is often made in conjunction with ‘consolidation’. More specifically, an attempt to define ‘pooling’ is made in the series of documents produced by the CCCTB Working Group. Pursuant to this, pooling appears to be a broader concept than consolidation. Its meaning thus focuses on the ‘aggregation of individual tax results of various group members’. The elimination of intra-group transactions is not critical. It may be part of the system but this is not obligatory. Yet, that is mentioned as a feature inherent in consolidation. It follows that the treatment of intra-group transactions is set forth, in the CCCTB works, as the test which circumscribes the distinction between consolidation and pooling.

The above test (i.e. elimination of intra-group transactions) as well as the understanding of pooling as a broader term is not entirely clear in Endres’ comparative tables in Intertax. Namely, the term ‘consolidation’ appears to be in use as a generic concept, which is classified as ‘group relief’ (UK), ‘group contribution’ (Sweden), ‘pooling’ (Germany, France, Denmark, Spain, US, Austria, Luxembourg) or ‘full consolidation’ (Australia, the Netherlands). Further, the elimination of intra-group transactions is not set forth as a test for distinction. Schemes of ‘full consolidation’ in principle do not appear attached to the term ‘pooling’. Yet, certain schemes allowing the elimination of intra-group transactions (i.e. Spain, USA) are categorised as pooling. That highlights some other
criterion for distinction. It does not look at the treatment of intra-group transactions. According to Endres’ classification, this could possibly relate to all those features which lead ‘fully consolidated’ groups to operate as a single unity. It is actually a situation closer to the ‘original meaning’ of consolidation, being that of aggregating financial statements.

Combined reporting in US State taxation, despite being conceptually distinct from national group taxation systems, still allows certain comparisons to be drawn. It thus lies closer to pooling, as it involves no elimination of intra-group transactions. Further, each group member files its own tax return and there is no alignment of individual tax bases.

The discussion of the concepts above urges the conclusion that any distinction between ‘consolidation’ and ‘pooling’ appears to make more sense in theory rather than in practice. The critical element is that both methods build a group tax base. In addition, integration happens through adding together the tax bases of individual group members rather than separate items of tax accounts. Apart from that, there are specific features which may bring the degree of integration closer to the concept of a ‘single unit’. Alternatively, they may hold it at the level of a looser tie among the group members. However, those variations do not point to critical disparities. It is only the possibility to eliminate intra-group transactions which seems to mark a significant difference in approach. This is because, through such elimination, the group tax base is not a mere aggregation of group members’ individual tax results.

733 Ibid.
734 ibid 351.
735 BF Miller, ‘Worldwide Unitary Combination: The California Practice’ in CE McLure Jr (ed), The State Corporation Income Tax: Issues in Worldwide Unitary Combination (Hoover Institution Press Stanford University, Stanford 1984) 133, 136 (hereinafter Miller): ‘...the combined report is used to determine the proper amount of income reportable by each entity engaged in a single unitary business...’.
736 For details on the comparison between `Combined Report` and `Consolidated Return`, see: Miller 136-137.
737 For instance, alignment of the factual history of a joining subsidiary with that of its parent reflects a considerable degree of integration within the group. This is the case in Australia. See: O’Donnel and Spence in IFA Cahiers 126 & 129.
anymore. Instead, the integrity of each separate member’s tax base is broken. This intervention brings the situation a step closer to the original concept of consolidation, being that of so-called ‘consolidation of financial accounts’. 739

II. The Group Tax Base and Allocation Systems: the Interrelation

(i) Consolidation/Pooling and FA

A question is whether the allocation of profit by FA to eligible group members can only be carried out in the context of a consolidated/pooled tax base.

The FA presupposes the existence of a group tax base. By nature, this cannot be compatible with systems, such as group relief or profit contribution, which function on an entity-by-entity basis. Therefore, where entities retain their integrity, there is in principle no room for allocation through apportionment. 740 The FA may apply to each single entity separately where an entity is liable to corporation taxes in more than one state. In such instances, the apportionment refers to tax jurisdictions eligible for a share in a specific entity’s tax base. Thus, in Canada, 741 in Switzerland 742 and those US States which do not apply unitary combined reporting, apportionment takes place within the framework of a single entity.

738 Systems which provide for individual tax liability of each group entity as well as separate return filing allow group members to retain their integrity and some degree of independence.

739 Wiman 354.

740 Some problems may be encountered in implementing HST where the state of the parent company applies a group taxation system of loss relief or profit contribution, as those schemes do not involve the creation of a single group tax base. The document produced on HST clearly identifies that states without a domestic system allowing consolidation of profits and losses have little or no advantage in adopting HST. See HST (Lodin and Gammie) 32.

741 Bird and Bream 1411.

It follows that, in the field of group taxation, the FA in principle requires that a single tax base becomes the basis for allocation of income to more than one entity or jurisdiction. The degree of integration of the single group base does not seem to have an impact on the FA. Namely, it is not as such likely to cause distortions. It will be discussed in Part B below that distortion may only be generated where disparate rules are applied in computing the group tax base.\textsuperscript{743} Further, the factors used in the FA may also create a distorted result, which will be an item for analysis in chapter 9. Therefore, the rules on tax base integration do not affect the accuracy of the FA insofar as the end-result is a single group base.

\textit{(ii) Consolidation/Pooling and Separate Accounting}

Consolidation/pooling could be compatible with separate accounting in a limited number of circumstances. For instance, many national group taxation systems in Europe and internationally operate under a combination of consolidation and separate accounting.\textsuperscript{744} The structures, though, which those schemes normally take, do not involve a pure division of the group tax base.

In a domestic framework, the group’s liability to tax normally arises in the name of the parent company and a credit is given for tax already paid by the subsidiaries.\textsuperscript{745} In such a context, separate accounting does not, in principle, raise transfer pricing issues, since all fiscal obligations arise within a single jurisdiction. Where a cross-border situation is in issue,\textsuperscript{746} the process is as follows: foreign results are taxed at the domestic rate, as part of the group revenues, after having been converted to

\textsuperscript{743} See later in this chapter at Part B, Section II.
\textsuperscript{744} IFA Cahiers’ General Report 2004.
\textsuperscript{745} Ibid.
\textsuperscript{746} In the EC, a cross-border aspect only applies to Austria, Denmark, France and Italy.
domestic tax results. A credit is then granted for tax paid abroad.\textsuperscript{747} This is apparently not a purely multi-jurisdictional scheme. Indeed, it looks more like computing a single entity’s tax liability rather than creating a group base for allocation. Within such a framework, transfer pricing concerns remain severe.

It follows, therefore, that consolidation/pooling may only be compatible with separate accounting under the following scheme: the tax base of each group subsidiary is computed separately and integration only involves the parent’s tax liability against which a credit is given for tax paid by the subsidiaries. Where division of the group base is envisaged, separate accounting is incompatible with the structure.

III. A Model of Tax Base Integration for the EIM

Only a scheme involving the creation of a single group tax base, in the form of consolidation/pooling, could serve a number of the objectives which the EC seeks to accomplish. Otherwise, systems such as group relief or profit contribution would provide a solution ‘targeted’ at dealing with losses or reducing taxable profits respectively. More specifically, a scheme of consolidation/pooling:

(i) allows intra-group loss relief;\textsuperscript{748}

(ii) is a prerequisite for applying the FA, which appears to be the only instrument available for replacing arm’s length separate accounting and so tackling transfer pricing formalities; in addition, the FA meets the needs of closely integrated markets more efficiently.\textsuperscript{749}

\textsuperscript{747} On Austria: MC Stefaner, ‘Die Neue Gruppenbesteuerung in Österreich als Kernstück der Steuerreform’ [2004] 8 SWK 418 (\textit{hereinafter} Stefaner); on Denmark: Amby in IFA Cahiers 241; on France: Borrat & Bassière in IFA Cahiers 279 et seq.; on Italy: Nobili & Lanza 566.

\textsuperscript{748} Staff Paper 372.

\textsuperscript{749} HST (Lodin and Gammie) 32: states without a domestic system allowing consolidation of profits and losses have little or no advantage in adopting HST; Musgrave (1984) 236-237: opportunities for profit shifting and structural interrelationships.
(iii) in conjunction with FA, can tackle certain tax avoidance practices at intra-group level without a need to apply Thin Capitalisation or CFC measures.\textsuperscript{750}

It can be concluded from the previous analysis that an EC group taxation scheme places no requirement for a policy choice of precisely ‘consolidation’ or ‘pooling’.\textsuperscript{751} It should be sufficient to create a structure of single group tax base coupled with a mechanism for allocating the group tax base to all eligible Member States. The elimination of intra-group transactions need not be treated as an indispensable feature. More detailed discussion on this will follow under Part C below. Indeed, it should be a core element of the project that each group member incurs a separate tax liability.

The above should suffice to create an EC group taxation system of highly integrated structure in the nature of consolidation/pooling. At the same time, the scheme will allow significant sovereignty to the group members, which is in conformity with the principle of subsidiarity.\textsuperscript{752}

\textbf{Part B: Harmonisation versus Diversity}

One fundamental question is whether a system of group taxation for the EC presupposes that common rules apply to calculating the group tax base. Any possible answers draw on the debate between the proponents of tax competition, on the one hand, and regulation, on the other. Earlier in the analysis,\textsuperscript{753} the opposing views, expressed in this regard, were highlighted and put into the context of the objectives pursued by the EIM. Discussion in this part will specifically focus on the tax base.

\textsuperscript{750} ibid. McIntyre (1994) (numbering not available in the electronic version).
\textsuperscript{751} See earlier in this chapter at Part A, Section I.
\textsuperscript{752} TEC art 5 subpara 2.
Further, harmonisation or diversity is relevant at two distinct stages of the process leading to the group tax base: (i) the calculation of each group entity’s (individual) tax base; and (ii) consolidation/pooling of the group members’ taxable results in the parent entity’s state of residence. As the issues raised at both stages bear significant similarities, they will be considered below as part of the same title. Finally, it will be shown that a combination of harmonised tax base and diversity in rates can create an efficient market where tax competition also has a presence.

I. Computation of the Tax Base

In principle, uniform rules apply within a group to computing each member’s tax base. That refers to the stage prior to consolidation/pooling of individual results. The majority of national systems of which the tests for entitlement to membership were described in chapter 6 do not accommodate any foreign element. They are namely confined to one single jurisdiction, in which case applying uniform rules across the group is a natural consequence. In Europe, it is only France (in the context of bénéfice consolidé), Denmark, Austria\(^{754}\) and Italy that provide for some form of cross-border group taxation. In those four states, the incorporation of foreign entities into the group requires conversion of their tax accounts to align with the rules applicable in the group’s state.\(^{755}\)

It is also interesting that a concept of uniformity is inherent in US unitary taxation. That is a system perceived and applied on a totally different basis from national

\(^{753}\)See Chapter 4, Part A and Part B, Section I.

\(^{754}\)Austria does not align the treatment of non-resident group subsidiaries with that of resident group members, in which a scheme of pooling is in force. It only allows foreign subsidiaries’ losses (and not profits) to be considered. A condition is that foreign results are converted into Austrian tax accounts. In addition, those should then be recaptured once the foreign subsidiary makes a profit or leaves the group.

\(^{755}\)For more details on France: Borrat & Bassière in IFA Cahiers 283; on Denmark: Amby in IFA Cahiers 240; on Italy: Nobili & Lanza 566; on Austria: Stefaner 418; KPMG Austria (2004) 39 et seq. & 62.
group taxation systems and, overall, does not present features of harmonisation.  
More specifically, each US State applies its own tax law for the purpose of computing its taxable share in a combined unitary tax base. As part of that process, the revenues of unitary entities resident in other US States need to be added up to the combined tax base. In that context, the tax accounts of those entities are converted to comply with the tax rules of the State carrying out the calculation. It follows that each US State's tax share arises out of a group tax base calculated under uniform rules.

The mechanism is however not centralised, in the sense that the allocation of the tax base is not carried out by one State for all entities of the combined group. Rather, each US State, being fiscal residence to at least one unitary entity, carries out a calculation, to the end of computing its overall tax share and then the share of each of its entities.

The use of own rules by each State creates distortion, consisting basically of double taxation due to an inevitable tax base overlap. Considering that each US State may compute the same unitary base under different rules, some parts of the combined revenues are inevitably caught by more than one State. Even a uniform FA across the US would not cure the problem. That is because double taxation is here the outcome of applying disparate rules to computing the combined revenue.

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758 It should be noted that double taxation is not in principle forbidden under US state taxation, except if it is found to be unconstitutional. A violation in this context would normally involve infringement of the Commerce Clause, which is discussed in Chapter 3. Further, the US tax system does not share the fundamental position of EC Tax Law that eliminating double taxation is a necessary step in the path towards an integrated market. See generally: Avi Yonah (1991) (page numbering not available on Nexis-Lexis).
759 CE McLure, 'The Incidence Incidence of Corporate Income Tax, the State Case' [1986] 70 Tax Notes Today 108 (numbering is not available in the electronic version), Moore at 1468 et seq.
Bringing the above discussion into an EIM context, the question is whether uniform rules should apply across the EC or, alternatively, each Member State should be free to abide by its own law. The latter could take a form either similar to US combined reporting or HST.

It is obvious that common rules should apply across each group to prevent tax base overlap. A system of EC-wide uniform treatment would apparently create a setting of efficiency. Further, neither would a scheme such as the HST give rise to distortion, providing that the parent entity’s state applies its rules across each group. Under the HST, it may be that more than one group taxation system would be in force across the EIM. Yet, no tax base overlap occurs if the calculation of each group’s tax liability is subject to one single regime.

It should be noted that, under the HST, some ‘foreign-held’ entities may be receiving less favourable tax treatment than domestically-held ones. That will occur where the domestic tax regime leads to a lower fiscal burden, as compared to that of the state of the group parent entity. The situation does not, though, point to infringement of the EC Treaty. This is because the higher tax burden would not result from a fiscal provision of the Member State in which the subsidiaries are resident. It follows that no discrimination/restriction, in line with the ECJ’s host-state analysis, can be established under this set of facts.

A scheme featuring the principles of US combined reporting does not appear to be an option for consideration within the framework of the EIM. Depending on the

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760 That would be of relevance if each Member State, host to one or more group entities, applied its own rules to calculating its share in the group tax base. In such case, there would be no uniformity in the rules applicable within each group.

761 Under HST, a group’s taxable base shall be computed pursuant to the law of the Member State in which the group’s parent company is tax resident. This involves both the computation of the tax base of each individual group entity and the method of tax base integration (consolidation, pooling, etc). See: HST (Lodin and Gamnié) 32.

762 ibid 21 para 1.1.

763 The expression ‘foreign-held’ is used for simplicity. The correct term would have been ‘held by a parent company resident in another EC Member State’.

764 See in this thesis: Chapter 1, Part A, Section II, Title (i).
remaining structural elements (e.g. FA or separate accounting), this would probably resemble an extension of national systems across the border. That would defeat the fundamental rationale behind the initiative taken by the European Commission for an EC-wide group taxation system. Thus, the system would remain as fragmented as it currently is. Further, double taxation as well as double non-taxation would persist. 765

It has been shown above that uniformity of the rules applicable within each group is necessary to prevent market distortion caused primarily by double taxation. Devising a system to apply across the EC meets additional needs which basically relate to simplicity. Still though, the objective of subjecting each MNE to one set of common rules across the EC could be achieved through a structure such as the HST.

II. Harmonisation: Tax Base versus Tax Rates

The proposals for group taxation, currently under consideration at EC level, put forward that harmonisation shall cover the group tax base and FA structure. 766 The determination of tax rates should remain under Member State competence, with the aim of allowing fair tax competition to flourish. 767 This policy decision is not self-evident. Thus, not all aspects of a tax system need to be harmonised. 768 Evidence is that, in the past, different harmonisation approaches were proposed by the European

765 Setting common rules in computing the group tax base is expected to lead to lower administrative costs for taxpayers. Further, it has been explained in chapter 4 that the elimination of double taxation may not create an obligation enforceable against the Member States before the ECJ. Yet, it is laid down in TEC art 293 as one of the objectives of the EIM.


767 Staff Paper 373.

768 Avi-Yonah (1991) (page numbering not available on Nexis-Lexis)
Institutions. For instance, in 1992, the report of the Ruding Committee set forth a proposal for a minimum and maximum tax rate.

It seems that there is no unanimous view about which elements of a group taxation system should be harmonised. As mentioned in Chapter 4 earlier, perfect neutrality places a requirement for uniformity in all elements of a group taxation scheme. Since, however, such an approach could undermine a system's flexibility and also produce additional distortions, it is believed that some amount of diversity should be allowed. Thus, some degree of tax competition has to be sustained within the EIM. On the other hand, disparity on a large scale would probably defeat the objective of devising an EC-wide group taxation system. This is because an obligation to comply with a number of different systems generates additional investment costs and, as a result, a higher burden for compliance. This is because market access becomes costly due to the market’s fragmentation into twenty seven disparate national systems. Those have been some of the key arguments put forward to justify the European Commission group taxation initiative.

As described under Section I above, the harmonisation of the tax base is an indispensable element of an EC-wide cross-state group taxation scheme. The reasons have been elaborated on under Section I.

Contrary to tax base divergence, rates seem to be a more suitable element to leave to the decision of the Member States. Especially where tax rate diversity is coupled with base uniformity, the system becomes transparent and comparison can be carried

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769 See earlier in this thesis Chapter 2; The Ruding Report Chapter 8; Proposed Losses Directive; Commission Proposal 1975.
770 The Ruding Report.
771 Gamma, in a less absolute view, agrees that ‘economic efficiency in the international allocation of resource ........ is unlikely to be attainable so long as each country’s tax system differs markedly’: M Gamma, ‘The Taxation of Inward Direct Investment in North America following the Free Trade Agreement’ (1993-4) 49 Tax Law Review 615, 631-632, Musgrave (1987) 287-289.
772 See earlier Chapter 4, Part A.
out more easily.\textsuperscript{775} Tax competition is normally expected to lead to rates decreasing rather than to a so-called ‘race to the bottom’. Practice has proved\textsuperscript{776} that, under such circumstances, rates are inclined to drop but only down to a certain point. This actually appears to reflect a ‘golden mean’, since the negative impact of tax shopping would be expected to be outweighed by rate decreases.\textsuperscript{777} At the same time, the taxpayers will still reap the benefits of tax competition.

\textbf{Part C: Elements of the Tax Base}

The title above may create the impression of incorporating a larger range of items than actually intended. This is why its content should briefly be clarified before proceeding with discussion. The analysis that follows is not meant to cope with specific individual elements of the tax base which one comes across at the level of a single entity.\textsuperscript{778} Instead, it focuses on items having a precise relevance to group taxation. Primary attention will be given to the treatment of intra-group transactions and payments, including transfers of capital assets.

It should also be clarified that issues relating to the group’s so-called ‘water’s edge’\textsuperscript{779} will not be analysed in this chapter but will instead be part of Chapter 8. For the purposes of this Part, it will be assumed that the envisaged EC-wide group taxation system does not extend beyond ‘water’s edge’. In an EC framework, this is roughly delineated as the territory of the EIM. The concept usually excludes entities resident outside the EC which do not maintain any intra-EC presence through a PE.

\textsuperscript{771} Staff Paper 223-224.  
\textsuperscript{775} Avi-Yonah (1991) (page numbering not available on Nexis-Lexis).  
\textsuperscript{776} ibid; Nov 329-330.  
\textsuperscript{778} WG Doc on Taxable Income.
Those cannot be part of the same EC group scheme, irrespective of being under common ownership or closely linked to each other from an economic point of view.

Among entities outside water’s edge, a distinction should be drawn between: (i) those affiliated with the group but resident outside ‘water’s edge’ and (ii) those having commercial dealings with the group but, otherwise, totally unrelated. The former are always tax residents outside the EIM; the latter may be resident either within the EC or in a third country.

All categories of entities (i.e. off-‘water’s edge’ and unaffiliated entities) fall outside the contours of the group taxation scheme. As a result, those transactions/payments will in practice be treated the same, irrespective of whether the payee or payer is in close economic ties with the group. The critical matter is to identify whether a specific entity is a group member. In practice, given the existence of group registration formalities, no uncertainty is expected to arise in this regard. Among the various classifications of non-group members, extra attention will be required for EC-resident entities due to their obligation to comply with the EC Freedoms.780

I. Revenues Qualifying as Part of the Group Tax Base

Intra-group transactions and payments take place between entities registered as members of the same group. A question is whether the consolidated/pooled tax base should accommodate all these results or instead be limited to items specifically linked to the group’s business activity. Intra-group dealings may in principle take the form of trading transactions (i.e. sales of goods and supplies of services), transfers of

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779 ‘water’s edge’ is discussed in Chapter 8 of this thesis. Roughly, the term is used in US ‘combined reporting’ to describe revenues earned within the territory of the country or through foreign-located PEs of US-incorporated companies.

780 These entities are subject to the test of ‘equal treatment’ for compliance with the fundamental freedoms. For more details, see earlier in this thesis Chapter 1, Part A.
capital assets or passive investment proceeds/distributions.\textsuperscript{781} It should probably be assumed that the first category of dealings is, by definition, inextricably tied up to an entity's business. It follows that those revenues would normally be classified as business income. Passive investment, on the other hand, gives rise to non-business income in most cases.

\textbf{The Uniform Division of Income for Tax Purposes (UDITPA)}

In discussing the significance of the distinction between business and non-business income for the group tax base, reference should be made to the UDITPA.

This is a Model Act created with the aim of a uniform approach to the division of income of multi-state enterprises across all eligible US States. The UDITPA dates back to 1957. It was then that the National Conference of Commissioners on Uniform State Laws and the American Bar Association approved it and recommended its adoption to the States.\textsuperscript{782} Further, the Multistate Tax Compact\textsuperscript{783} has almost verbatim reproduced UDITPA.\textsuperscript{784} This is not a federal act laying down enforceable obligations. Rather, it is only a framework which provides guidance on how the US States should structure their business tax systems. The objectives of UDITPA focus on minimising multiple taxation of inter-state and foreign commerce. Thus, a set of uniform rules, consisting of a three-factor formula, has been proposed for allocating the group tax base to the eligible US States.\textsuperscript{785} That also included uniformity in computing the consolidated/pooled tax base.

\textsuperscript{781} WG Doc 4 on Group Taxation paras 26-39.
\textsuperscript{783} The Compact is a model of state tax statute and its application is currently under the supervisory control of the Multistate Tax Commission.
\textsuperscript{784} Sherrod 2336-2337.
\textsuperscript{785} ibid 2336.
The UDITPA has been structured on the basis of a distinction between business and non-business income. The former is apportioned to the eligible US States whereas the latter is allocated to the state which the income is most closely associated with. That is often the state of the company’s commercial domicile. The distinction between business and non-business income is inextricably linked to the concept of unitary taxation. This limits the revenues which become consolidated at group level and apportioned through the three-factor formula to those being part of the unitary business. Inevitably, therefore, non-business income is kept outside the group. Under the US unitary rules, revenues and costs of passive investment are not included in the group tax base for apportionment.

In connection with non-business income, the UDITPA contains proposals for specific allocations. More specifically, rents are taxable in the state where real and tangible personal property is situated or utilised. The same links are in principle relevant when it comes to the sale of property. Further, interest and dividends are allocated to the state of the beneficiary’s domicile. Finally, royalties (i.e. patents and copyright) are attached to the state in which the relevant intellectual property rights are exercised.

The distinction between business and non-business income is not always easy to draw. The state Supreme Courts have often disagreed on the tests which should be employed to define income in the context of the UDITPA. The question has been whether the decision should be made exclusively on the basis of a transactional test or, instead, transactional and functional tests can be treated as alternatives. The

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786 "...income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations..." UDITPA 1(a).
787 "...all income other than business income..." UDITPA 1(e).
790 Russo 13.
791 Russo 13.
jurisprudence of state Supreme Courts has answered this question through the language and legislative history of the relevant provisions.\footnote{In the following cases, the state courts, based on the wording of the relevant provisions, came to the conclusion that the only test for defining business income was the transactional test: General Care Corp. v Olsen 705 S.W.2d 642 (Tenn. 1986); In re Appeal of Chief of Industries Inc. 875 P.2d 278 (Kan. 1994); Phillips Petroleum Co. v Iowa Dept of Rev and Finance 511 N.W. 2d 608 (Iowa 1993). Again, following the language of the provision, decisions were taken in favour of both tests in: Texaco Cities Service Pipeline Co v McGaw 695 N.E.2d 481 (Ill. 1998); Simpson Timber Co. v Dept of Revenue 953 R2d 366 (Or. 1998); Laurel Pipe Line Co. v Commonwealth Board of Finance and Revenue 642 A.2d 472 (Pa. 1994).}

An example in this area is **Polaroid,**\footnote{Polaroid Corp. v Offerman 349 N.C. 290, 507 S.E.2d at 284 (1998); cert. denied, 119 S. Ct. 1576 (1999).} decided by the North Carolina Supreme Court in 1998. The dispute involved the classification of proceeds from litigation. Polaroid Corporation received proceeds from litigation with Kodak, which it treated as non-business income. As a result, the amount was allocated to the company’s commercial domicile in Massachusetts. Disagreement arose with the Department of Revenue which took the position that the amount qualified as business income. The North Carolina Supreme Court interpreted the provision in issue and found against the taxpayer. It ruled that North Carolina’s corporate taxation accommodates both the transactional and functional tests. Further, the court supported its position by referring to the wording of the statute.\footnote{...includes income from tangible and intangible property if the acquisition, management and/or disposition of the property constitute integral parts of the corporation’s regular trade or business operations’ (N.C. Gen. Stat. 105-130.4(a) (I) (1997)): the ‘and/or’ wording of the statute was taken to mean that the asset from which income is derived does not have to be an item of the corporation’s normal course of trade. This is so provided that the acquisition or management of the property is an integral part of the taxpayer’s operations.}

In practice, this meant that the proceeds in dispute could qualify as business income under either the transactional or functional test. The former is a narrow construction which looks at the nature of a transaction. It thus requires that the gain be produced by a type of transaction in which the company regularly engages in its normal course of business.\footnote{Sherrod 2339.} The functional test is concerned with the nature of the asset. To classify revenue as business income, it suffices that a certain asset was used to
generate business income, irrespective of whether the transaction itself was a regular part of the corporation’s business.\textsuperscript{796}

The distinction between business and non-business income operated by the UDITPA is closely related to the concept of unitary taxation.\textsuperscript{797} Namely, a strictly unitary definition of business leaves proceeds from passive investment outside the group tax base. That is a natural implication, as those items of income do not derive from the group’s trade activity. As explained in chapter 6, it is doubtful whether a strict unitary approach would be an optimal solution for the EIM. Rather, it seems that an ownership-based test for group entitlement, coupled with some anti-abuse terms, would be easier to adopt.\textsuperscript{798}

In light of this, the exclusion of non-business income from the tax base could create more complexity than provide solutions. Thus, leaving non-business income outside the group tax base and FA would result in subjecting a good number of items to separate accounting source/residence rules. This would necessitate that transfer pricing rules be retained extensively in the system. Further, the group taxation scheme will be deprived of a number of opportunities to receive loss relief.\textsuperscript{799}

On the other hand, limiting the tax base of an ownership-based group to solely business income could contribute to more accuracy of the final tax liability. As explained in chapter 6,\textsuperscript{800} apportioning a group tax base which extends beyond the contours of a single business inevitably leads to distortion.\textsuperscript{801} Yet, if only business income is incorporated in the tax base, a certain degree of coherence could be possible to attain among the amounts apportioned. Still though, an attempt to draw the distinction between business and non-business income could prove a difficult exercise. The taxpayers would encounter similar problems to those of defining a

\textsuperscript{796} Ibid.
\textsuperscript{797} For the concept of unitary taxation, see Chapter 6, Part A, Section III.
\textsuperscript{798} WG Doc 3 on Group Taxation paras 5-9; WG Doc 4 on Group Taxation paras 13-14.
\textsuperscript{799} Russo 13.
\textsuperscript{800} Chapter 6, Part B, Section I.
unitary business. Thus, if a unitary definition for group membership is rejected due to its legal uncertainty, limiting the group tax base to business income does not appear a justified policy choice.

A consequence of determining group membership primarily through ownership tests is that, in principle, all transactions and payments can be entitled to inclusion in the scheme. This is because no consideration of business unity is part of the picture here. The European Commission has expressed its position on this matter in the context of the debate on the CCCTB. In an attempt to build the group tax base as widely as possible, the Commission seems to be in favour of making passive income part of the apportionment.

II. The Categories of Transactions and Payments

(i) Trading Transactions

Intra-group trading transactions deal with sales of goods or services among group members. Pursuant to rules on separate accounting, they constitute an expense to the recipient entity and an item of revenue to the seller. International Tax rules normally render the seller liable to tax in the Member State of its tax residence, unless services are physically provided at the recipient’s residence. This last situation is limited to

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802 W Hellerstein (1982) 158: it was stated in Mobil and then repeated in Exxon: 'the linchpin of apportionability in the field of state income taxation is the unitary-business principle'.
803 For the various definitions of a unitary business, see: Chapter 6, Part A, Section III.
804 The distinction between business and non-business income is relevant to all group taxation systems. Therefore, the fact that the Commission expressed its view in connection with the CCCTB is of no practical significance.
805 Commission (EC), 'An overview of the main issues that emerged at the third meeting of the subgroup on international aspects (SG 4)' (Working Document) CCCTBWP049\doc, 23 November 2006, 7 (hereinafter WG Doc 4 on Int'1 Aspects).
806 Weiner (2005) 32.
cases of PE presence, where a DTC is in place between the respective jurisdictions. In the absence of a DTC and provided that there is no PE presence, a withholding tax would normally be applied at source.

1. The Elimination of Intra-Group Transactions

Schemes of consolidation treating the group as a single entity normally also provide for the elimination of intra-group transactions. This is demonstrated in national group taxation systems applying consolidation. In Australia, intra-group transactions are ignored, as the assets and liabilities of each entity are simply attributed to the head group company.\(^\text{806}\) There is thus no need, unlike most other countries, to keep track of the cost of the shares or interest in subsidiary members while they remain in the consolidated group.\(^\text{807}\) When an entity leaves the group, the current cost of the assets of the leaving entity less its liabilities is ‘pushed up’ to the shares in the company.\(^\text{808}\) In Spain, elimination applies but, once eliminated income is realised with third parties, it is restored to the consolidated result.\(^\text{809}\) Equally, inter-company items are adjusted, at entity level, to achieve single entity treatment in the USA. That involves the elimination of dividends and an adjustment of inter-company sales which are deferred until realised outside the group.\(^\text{810}\)

A number of options on how to implement the elimination of intra-group transactions are open to tax administrations.\(^\text{811}\) Depending on the path taken, there are certain implications mainly related to the treatment of eliminated profits/losses once those are realised by a third party or the entity leaves the group. In that case,

\(^{806}\) O’Donnel and Spence in IFA Cahiers 134; Gree morals and Freehills Guide to Tax Consolidation for Corporate Groups in Australia (Greenwoods and Freehills Pty Ltd, 2005)


\(^{807}\) Ibid 12.

\(^{808}\) Ibid.

\(^{809}\) Grau Ruiz in IFA Cahiers 622-623.

\(^{810}\) Sparagna in IFA Cahiers 718.

\(^{811}\) WG Doc 2 on Group Taxation paras 13-15.
the eliminated intra-group results have to be recaptured and added back to the tax base. 812

The Working Group on the CCCTB has explored ways of dealing with intercompany relations. Initially, two options were put forward for discussion: intra-group payments may either be disregarded completely or recorded at cost. 813 The choice between the two basically involves a decision between rendering intra-group transactions invisible in the group tax base and allowing them to appear at cost value. Later on, a third option was added for discussion: to record the internal transfer price with elimination of internal profits/losses. 814 However, it was finally concluded that no obligation should be placed on groups to price their internal transactions at arm’s length. 815 This is because the amount of profit or loss on which the transfer price impacts is eliminated.

Ignoring the intra-group transactions would contribute to simplicity, since that would escape the need to devise a common definition of cost. 816 Further, the cost of transactions would have to be computed on an on-going basis, which does not seem to make a huge difference from adjusting to arm’s length. That would certainly require extra effort in the field of compliance. In addition, it would bring back some transfer pricing concerns, being one of the targeted areas under the EC group taxation initiative. On the flip side, the drawback of this approach is that it does not allow a payments’ ‘trail’ 817 to be retained at group level. Still though, this is most likely to be kept in the accounts of each participating group entity. 818 By implication, in the event of a need to check those results, it would in principle be possible.

812 WG Doc 4 on Group Taxation paras 37-39.
813 WG Doc 1 on Group Taxation paras 8-9.
814 Ibid.
815 WG Doc 2 on Group Taxation para 15.
816 WG Doc 4 on Group Taxation para 33.
817 Ibid para 34.
818 Ibid para 38 et seq.
819 Ibid para 38.
The bottom line in the above discussion is that there is no perfect path in eliminating intra-group transactions. There are advantages and weaknesses on both sides. In such cases, a decision is often taken through assessing external factors. For instance, given the unanimity rule, the Member States may just opt for the solution on which there is agreement.

2. The Treatment of Losses

Cross-border intra-group losses are relieved through the consolidation/pooling of the group members' individual results. Apart from this aspect, however, the treatment of losses also becomes an issue for consideration in a number of other cases.

The Working Group on the CCCTB has identified certain fields related to losses which require specific regulation.\textsuperscript{820} The first area concerns pre-acquisition losses. There seems to be agreement that those should be compensated with the part of the CCCTB attributed to the respective group member. This is roughly the principle shared by most national group taxation systems applying consolidation/pooling.\textsuperscript{821} The remaining three cases involve losses incurred by the group. Those should in principle remain at group level and not be shared by the individual members. The experts sitting in the Working Group were divided as regards the treatment of a loss-making group which terminates. Some favoured attribution to the parent while others (among which the Commission) an allocation to all group members according to the shares established in the last FA.\textsuperscript{822} Finally, agreement was reached that, within a loss-incurring CCCTB group, ‘leavers’ should not be entitled to relief for part of the losses. This is in line with the thinking that the group should be treated as a single entity.\textsuperscript{823}

\textsuperscript{820} WG Doc 4 on Group Taxation paras 21-25.
\textsuperscript{821} Austria, Denmark, France, Luxembourg, the Netherlands, Portugal, Spain; see Endres 350-351; M dos Prazeres Louza, ‘Report on Group Taxation in Portugal’ in IFA (ed), Cahiers de droit fiscal international vol 89b (Cahiers de droit fiscal international, IFA, 2004) 547, 555.
\textsuperscript{822} WG Doc 4 on Group Taxation para 25.
\textsuperscript{823} ibid para 24.
The above input produced as part of the work on the CCCTB is also valid for HST as well as any group taxation project envisaging the creation of a single group tax base.

(ii) Transfers of Capital Assets

Transfers of capital assets broadly give rise to issues similar to those arising in trading transactions. Again, the Working Group for the CCCTB has produced interesting thoughts relevant to any EC-wide group taxation of consolidation/pooling.

The treatment of underlying capital gains has been spotted as an area giving rise to tax avoidance concerns. In internal transfers, capital gains are eliminated through consolidation. The question is whether this gain should be taxed when the entity which received the asset leaves the group or the group terminates. In the event of a transfer of shares, a participation exemption may apply, in which case the transfer is left untaxed. In such a context, there is a risk of tax abuse consisting of transferring assets tax-free to a group entity which soon leaves the group. If that is a result of a sale of shares, participation exemption in principle allows the underlying capital gains to remain untaxed. The proposal put forward in the reports of the Working Group on the CCCTB is to treat sales of group entities as transfers of assets. The aim should be to escape application of a full participation exemption.

No definitive position has yet been reached on the above matter by the CCCTB Working Group. An aspect for further elaboration concerns cases of transfers of

824 HST (Lodin and Gammie) 32.
825 WG Doc 3 on Group Taxation paras 13-15; WG Doc 4 on Group Taxation paras 36-46.
826 WG Doc 3 on Group Taxation para 14.
827 Ibid.
828 WG Doc 4 on Group Taxation paras 42-43.
829 Ibid para 43.
shares to companies outside the group but otherwise resident in the EC. In light of
the proposal that sales of group companies should qualify as asset disposals, there
could be a risk of infringing the prohibition to impose exit taxes. This would thus
be so if capital gains tax became due upon the transfer.

By way of an additional point, the Commission has highlighted the need to record
assets on each group entity’s accounts at their tax depreciated value. The aim is to
ensure that, upon a transfer to a non-group member, the value of an asset is correctly
depicted in the accounts. This appears a necessary process to allow control over
depreciation and prevent double depreciation.

(iii) Payments of Dividends, Royalties and Interest

Eliminating intra-group payments of dividends, royalties and interest implies that the
respective provisions of the DTCs in force will not be applicable. As discussed
earlier in this chapter, this should not give rise to particular complexities in view of
the principle of supremacy of EC Law.

If the Member States opt for keeping passive income outside the group tax base, a
decision on specific allocation rules may need to be taken. An alternative view is to
devise a separate mechanism for the allocation of passive income. If a system of
specific allocation is established, the EC Directives on dividends, interest and
royalties could be applied. That would allow the taxpayers to make use of the fiscal

830 See de Lasteyrie; N; for the test of equal treatment, see Chapter 1, Part A.
831 WG Doc 1 on Group Taxation paras 9-10.
832 Ibid.
833 WG Doc 4 on Int’l Aspects paras 11-12.
834 P-S Directive art 5 (on prohibiting withholding taxes at the state of the subsidiary) & art 4(1) (on
relief methods at residence); I & R Directive art 1(1) (on prohibiting withholding taxes at source). See
also earlier in this thesis Chapter 2, Part B.
benefits attached to their provisions. In addition, this is a legal framework which the Member States have been familiar with for years. In that way, extra regulation aimed at arranging for a second allocation method, possibly similar to UDITPA, can be avoided.

Conclusion

An attempt was made in this chapter to clarify the main concepts related to models of tax base integration. It has been shown that the apportionment of income by formula (FA) may only be compatible with systems that involve the creation of a single group base. Thus, consolidation or pooling should in principle fulfil this requirement.

The degree of required harmonisation has also been discussed. It was concluded that distorted effects due to double taxation can be avoided so long as uniform rules for the tax base apply within each group. That would make a proposal such as the HST a valid option to consider. Indeed, a single set of rules across the EIM, in the form of the CCCTB initiative, would certainly contribute to simplicity. However, this is not a conditio sine qua non to fulfil the objectives set in the EC policy documents on company taxation. Further, diversity in tax rates does not harm the system. On the contrary, it retains an amount of tax competition which is necessary to keep the market in balance.

835 Both Directives provide for no withholding tax to be applied at source; further, pursuant to the P-S Directive, the taxing Member States may make a decision between applying exemption or credit for relief at residence. If they choose the second option, credit should be given for the underlying tax.
836 Staff Paper Part I.
837 A complete uniformity of tax bases and rates in the EC would be likely to cause market distortion in the sense that it would favour the larger economies among the Member States.
Finally, some thought was given to the possibility of implementing the UDITPA distinction of business/non-business income to the EC. The outcome has been that adopting this concept in the EC would give rise to similar problems as those related to defining a unitary business. In any case, this distinction is inherent in the system of unitary taxation. Therefore, if the option of an ownership-based group is taken, there is no point in adding complexity to the scheme.
8. TERRITORIAL SCOPE OF THE GROUP

Introduction

In discussing a group's territorial scope, the principal concepts which come to the fore are 'water's edge' and 'worldwide' combined reporting. Both terms were created and then evolved in the context of US States' corporate taxation. The concepts feature two different (if not opposing) ways for delineating the geographical scope of a unitary business. They point to one of the most debated matters in the field of US sub-national income taxes. Roughly, the conflict boils down to whether combined reports should incorporate the worldwide income of a unitary enterprise or be limited to income earned within the US territory.

In an EC-wide group taxation system, defining the territorial scope is one of the key issues. Up to now, the clear policy choice of the EC has been for a 'water's edge' scheme. It has been present in all policy documents on group taxation issued since 2001.\(^838\) Further, literature in the field of EC group taxation does not, in principle, depart from water's edge.\(^839\)

The choice for water's edge will not be challenged in this thesis. In this chapter, it will be discussed how worldwide combined reporting created tension and allowed it to soar in US external relations. The events of the 1980s and 1990s are convincing


\(^{839}\) See generally: HST (Lodin and Gammie) 45-46; McLure & Weiner; Weiner (2002a); M Levin, Harmonising Corporate Tax bases in the EU (Prospectus for CEPS Task Force, Centre for European Policy Studies, 2002).
enough to drive EC policy away from worldwide combination.\footnote{See later in this chapter Part A.} It should also be pointed out that worldwide combination is complementary with the concept of unitary business, which, by definition, takes no consideration of state borders.\footnote{This is because the unitary tax base, by nature, ignores entity structures. It, rather, incorporates income on the sole criterion of deriving from the single unitary enterprise. No other qualifying factor should be met.} Yet, EC group taxation should not be expected to take the form of a scheme primarily based on unitary principles.\footnote{Yet, EC group taxation should not be expected to take the form of a scheme primarily based on unitary principles.} In light of this, worldwide combination has not been given credit as a policy option for the EC.

A number of issues arise in rendering water’s edge workable within the EIM. It all boils down to how EC inbound and outbound payments interact with the group taxation system in place. The key complexity will feature in the cases where the allocation of group profit through apportionment meets separate accounting applied to foreign income. Part A will focus on outlining the historical evolution of worldwide combined reporting and water’s edge in the US. Features inherent in worldwide reporting which fostered conflict will also be analysed. Part B will bring the discussion to the EIM. An attempt will be made to justify the policy choice of ‘water’s edge’ for the EC. Further, discussion will be carried out of the US and EC constitutional principles and market objectives with a bearing on the territorial scope of the group. In addition, the elements which are relevant to an EC group taxation system of water’s edge will be examined in detail. Analysis should involve the consideration of rules for determining which affiliated entities are entitled to participate in water’s edge. Finally, effort will be made to reach conclusions on which group schemes and revenues should be included in, or excluded from, the water’s edge tax base. Schemes for treatment of inbound and outbound payments within a ‘water’s edge’ system will be given special focus. The aim should be to identify the least troublesome options.
Part A: How a Territorial Definition of the Combined Group Evolved in the US

When it comes to the discussion of worldwide combined reporting and 'water's edge', the US is the only jurisdiction to explore. Thus, there is no legislative framework for group taxation in Canada or Switzerland. As a result, the geographical scope of the group is an unknown concept in those jurisdictions.

With California at the forefront of development, combined reporting emerged from US State-level income taxation and evolved throughout the twentieth-century American history. In this Part, an outline will be given of the historical path which brought combined reporting from the 1930s to Barclays, just before the mid-1990s. Special reference will be made to the reasons which led the US States to concede the 'water's edge' election. Thus, knowledge of the background to unitary combination in the US is expected to provide input in making policy decisions for the EIM.

I. Historical Development

Worldwide combination evolved in parallel to unitary taxation in the twentieth century.

842 The tests for determining group membership entitlement are discussed in Chapter 6 of the thesis. The position taken is that a technical test based on holding percentage appears to suit the EC structure and objectives better than any other alternatives.

The precursor of combination involved apportioning the revenues of a single firm operating a business which extended to more than one US State.\textsuperscript{844} It thus arose out of the same needs which generated the concept of a unitary business. Illinois adopted a state railroad tax in 1872 that allocated tax liability to \textit{'each county, city or town by reference to the length of track within the locality compared with the total length of track'}.\textsuperscript{845} That method of apportionment was later extended to the newly introduced state income taxes.

The way to combined reporting was led by California. The apportionment of combined income of a group of corporations, understood to form a unitary business,\textsuperscript{846} is a development of the 1930s. More specifically, combined reporting was initially proposed by the California Franchise Tax Board (FTB). The aim was to combat a practice of the motion picture industry, consisting of producing films in California and then transferring them out of state for distribution.\textsuperscript{847} At around the same time, there are reports of the first cases extending across the US border to incorporate affiliate foreign companies.\textsuperscript{848}

\textit{Matson Navigation}\textsuperscript{849} was the first judgment of the California Supreme Court under the Bank and Corporation Franchise Tax Act. The Court held that tax liability arose from income attached to both interstate and foreign commerce, despite the absence of relevant reference in the tax statute.\textsuperscript{850} The above Act was amended in 1939, for the purpose of incorporating the changes already in place through jurisprudence. It should be mentioned that, until the 1960s, there was no concrete view that worldwide combination should be the rule in determining corporation franchise tax liability. The focus was on reporting income fairly. The precise methodology did not

\textsuperscript{844} Carlson & Galper 5.
\textsuperscript{845} Houghton 457.
\textsuperscript{846} Carlson & Galper 5.
\textsuperscript{847} Houghton 457; Miller 137.
\textsuperscript{848} Carlson & Galper 6.
\textsuperscript{849} Matson Navigation Co v State Board of Equalisation S.F. No 15137 Cal Sup Ct (1935); 3 Cal. 2d 1; 43 P.2d 805 (hereinafter Matson Navigation).
\textsuperscript{850} Miller 138.
attract much attention.\textsuperscript{851} Rather, separate accounting appears to have been the rule. Combined reporting and the allocation of the tax base by formula were only employed where tax avoidance issues were raised.\textsuperscript{852} Further, it has also been in the 1930s that the League of Nations concluded that the FA should be rejected in favour of arm’s length separate accounting.\textsuperscript{853}

\textit{Honolulu}\textsuperscript{854} and \textit{Superior}\textsuperscript{855} jurisprudence marked a shift towards combination. Briefly, the California Supreme Court ruled that, whenever there is a unitary business, FA and worldwide combination should be applicable.\textsuperscript{856} Worldwide combined reporting became the rule in calculating corporation franchise tax in California throughout the 1960s and 1970s. Foreign banks seem to have been the first area in which income derived from foreign-controlled businesses was considered.\textsuperscript{857} Further, in July 1972, the above practice was institutionalised through the adoption, by the FTB of California, of a set of working rules for incorporating foreign corporations into combined reports.\textsuperscript{858} Other US States followed later. Florida launched worldwide combination in 1983\textsuperscript{859} when controversy was already well on.

Signs of potential conflict on worldwide combination were shown as early as the 1970s. A ‘water’s edge’ provision was initially agreed in the context of the US-UK DTC of 1975 but was then (i.e. 1978) not retained by the Senate at the ratification stage.\textsuperscript{860} The US States experienced pressure from foreign governments, MNEs and

\textsuperscript{851} ibid 137-138.
\textsuperscript{852} Ibid.
\textsuperscript{854} \textit{Honolulu Oil Co v Franchise Tax Board} S.F. No 21210 Cal Sup Ct (1963); 60 Cal. 2d 417; 386 P.2d 40 (hereinafter \textit{Honolulu}).
\textsuperscript{855} \textit{Superior Oil Co v Franchise Tax Board} L.A. No 26672 Cal Sup Ct (1963); 60 Cal. 2d 406; 386 P.2d 33 (hereinafter \textit{Superior}).
\textsuperscript{856} Miller 139.
\textsuperscript{857} ibid 140.
\textsuperscript{858} Houghton 458.
\textsuperscript{859} Ibid.
\textsuperscript{860} ibid 458.
the US Federal Government to do away with worldwide combination. In litigation, worldwide combination was challenged as regards its compatibility with the constitutional clauses of Due Process and the ‘dormant’ Foreign Commerce. These concepts have extensively been discussed in chapter 3 of this thesis.

The US Supreme Court was called upon to rule on the constitutionality of California’s worldwide reporting for the first time in 1983. Container, the taxpayer, was a US-based MNE with subsidiaries across the US and abroad. It challenged the three-factor FA employed in California against its conformity to the Due Process and Commerce Clauses. The Court, noting that it is often impossible to allocate values to territories with precision, went on to say that there is no constitutional requirement for a single US States’ FA. It was held that FA should be fair and non-discriminatory. Those requirements were not found to be infringed if ‘some income that did not have its source in the taxing State’ is subject to taxation.

Applying Japan Line, the Court set forth arguments for the purpose of proving that the Foreign Commerce Clause was not in breach. In considering multiple taxation risks, it was mentioned that double taxation was not inevitable. Therefore, no violation of one of Japan Line’s tests could be sustained. Yet, the Court refrained from adjudicating on whether the same conclusion would be reached in the event of a foreign-owned MNE. The matter was resolved in Barclays ten years later. As regards federal uniformity, no infringement was found. The Court based its


863 Ibid 170.

864 Altonian 1158; Whitman 270.

865 Altonian 1160; Whitman 270.
thinking on two grounds: (i) there was no implication of the country’s foreign relations, and (ii) there was no indication of a federal policy against the use of FA.

In the aftermath of Container, US President Reagan did not file a motion for rehearing. Instead, he formed a Working Group, comprising federal and state government representatives as well as members of the business community. The aim was to reach agreement on restricting the application of worldwide combination. However, the attempt turned out unsuccessful, which led the UK to threaten retaliatory measures in 1985. As a consequence, some states passed ‘water’s edge’ legislation.

The situation escalated in 1993 when the UK announced retaliatory measures against US-based companies active in the UK. The clash was prevented, as California reformed its ‘water’s edge’ election, already in force since 1986. No fee was required any longer for tax years beginning on, or after, 1st January 1994. The filing of a domestic disclosure spreadsheet was also abolished. A year later, the US Supreme Court ruled on the constitutionality of California’s worldwide combination in Barclays.

The case concerned a UK-based parent with US subsidiaries treated as a unitary business for California franchise tax purposes. The system was again found to be in conformity with the Due Process and Commerce Clauses. The Court produced an interesting reasoning on multiple international taxation which was the outcome of applying FA. It was held that separate accounting does not, in principle, offer any better guarantee for eliminating (or lessening) multiple taxation. Further, the Court

866 Houghton 458.
867 Ibid.
868 Ibid 458-459.
869 See generally for individual States policies: Houghton 463 et seq.
870 Ibid 459.
871 Ibid.
saw no reason why foreign-owned MNEs should be treated differently from domestic ones as regards multiple taxation risks. It was asserted that, in both cases, double taxation depends on the facts of each individual case. The Court also dealt with the test of federal uniformity impairment contained in *Japan Line*. Use was made of the concept of the ‘dormant’ Commerce Clause. The Court accepted that worldwide combination had implicated the US foreign relations but held that there had been a passive acquiescence in that practice.\(^{873}\) Thus, abstention from taking action to do away with the practice was found to indicate an implicit permission.

*Colgate*,\(^ {874}\) a case which was decided by the US Supreme Court in a consolidated action with *Barclays*,\(^ {875}\) attempted to establish that there had been a clear federal policy against allowing worldwide combined reporting. Yet, the Court's reaction to this was that the power to regulate foreign commerce rests with the Congress and not with the Executive.\(^ {876}\)

II. The Post-*Barclays* State of Affairs

The judgment in *Barclays* was followed by litigation generated in the US States applying the ‘water’s edge’.\(^ {877}\) The questions raised often involve the validity of such systems under the Foreign Commerce and Due Process Clauses. Ground for challenge has usually been the incorporation of foreign dividends into ‘water’s edge’ reports whilst the foreign payers' factors remain absent from the FA.\(^ {878}\)

\(^{873}\) Altonian 1160, Whitman 273-274.
\(^{875}\) In *Colgate*, the US Supreme Court initially denied review but, following a petition by both *Colgate* and *Barclays*, granted certiorari in a consolidated action: 114 S. Ct. 2268 (1994).
\(^{876}\) *Barclays* 2285.
\(^{878}\) ibid 1306 et seq.
The US States did not, in principle, react to Barclays by switching back to worldwide combination.\(^{879}\) It should be noted, though, that the work of the Multistate Tax Commission (MTC)\(^{880}\) reveals an intention to return to more expansive unitary filings.\(^{881}\) More specifically, a uniformity proposal for a Model Combined Reporting Statute was passed by Resolution of the MTC on 17\(^{th}\) August 2006.\(^{882}\) Section 5.A. lists which members of a unitary group shall be part of the combined report if a ‘water’s edge’ election is made. Details will be given under Title II of Part B of this chapter. Yet, it should be noted, at this stage, that the proposal is for a broad definition of ‘water’s edge’. For instance, when it comes to unitary members incorporated outside the US, the combined group is not limited to income derived from a PE of the above members located in the US. Rather, the contours of the group extend to all unitary income generated in, or attributed to, sources within the US.\(^{883}\) That is, namely, irrespective of the existence of a PE.

III. Comments on the Conflict Generated by Worldwide Combination

Worldwide combination in the US has been a creation inextricably linked to unitary taxation. In that context, each eligible State is allocated a portion of a business’ overall revenue, for the purpose of charging tax. The overall revenue (i.e. group tax base) is computed according to principles of unitary taxation which aim at retaining the unity of business. This is because the fragmentation of a single business distorts


\(^{880}\) Houghton 461.

\(^{881}\) ibid 457; for details on the works of the MTC, see: ibid 460 et seq.

\(^{882}\) Multistate Tax Commission, Proposed Model Statute for Combined Reporting, as approved by the MTC Executive Committee for Bylaw 7 Survey, 21 June 2005 (hereinafter MTC Model).

\(^{883}\) ibid s5.A.iv.
the outcome of tax base allocation. Worldwide combined reporting is an outcome of the above practice. It is namely part of the method used to arrive at the unitary tax base. ‘Water’s edge’, on the other hand, retains only the part of a single business attaching to a delineated territory. Therefore, as a point of principle, it compromises business unity. Yet, a number of reasons necessitated departure from worldwide combination in the US. In the discussion below, an attempt will be made to identify them.

Two words seem to incorporate all rationale behind the controversy which worldwide combination gave rise to: higher costs. Opposition to this state practice came from three different groups of interest: MNEs, the US federal government and foreign governments. The reasons which incited reaction were straightforward. MNEs did not wish to endure higher taxes and compliance costs than under a system of traditional international tax rules of source/residence. The US federal government was concerned that investment may be driven out of the country due to worldwide combination acting as a disincentive. Further, foreign states exerted pressure on the US federal government in support of their companies’ exporting financial interests.

One of the key negative aspects of worldwide combination in the US is that it causes double taxation. Situations which lead to double taxation are: (i) the tax base overlap and (ii) the differences in profitability among jurisdictions which have taxing rights over members of the (worldwide) unitary group.

By way of initial comment, it should be noted that both the above factors causing double taxation are also present in ‘water’s edge’ schemes. Namely, each US State determines its taxable share individually. There are no uniform rules for tax base composition. What’s more, each State makes use of its own version of FA. Under such circumstances, a tax base overlap is inevitable. Yet, the differences among state rules are not huge. This is partly because the federal tax base and the ‘Massachusetts

\textsuperscript{884} see generally: McLure (1984).  
\textsuperscript{885} Houghton 458 et seq.
Formula’ for apportionment constitute common starting points for taxation. By contrast, in a worldwide framework (i.e. US and foreign unitary members), disparities in fiscal systems are significant. Further, profitability gaps are expected to be much sharper in a global context than domestically. All this renders double taxation severe under a worldwide combination structure.\textsuperscript{887}

Profitability differences, as a cause of double taxation, require some further explanation. Foreign corporations are, by average, more profitable than US-resident members of a unitary business.\textsuperscript{888} That is expressed by a higher ratio of income to apportionment factors for overseas unitary members, as compared to US-resident ones.\textsuperscript{889} The result is that the US States attract, upon apportionment, a larger portion of the combined group base than they would under ‘water’s edge’. That is because, due to higher returns in certain parts of the unitary business, income grows whereas the factors remain stable in the FA. Therefore, within a scheme of worldwide combination, jurisdictions of lower profitability benefit from the results of higher-profitability states. In practice, part of the income earned by foreign members of the unitary group becomes taxable within the US, which equals extraterritorial taxation.\textsuperscript{890}

Complex administrative compliance obligations are another considerable source of cost for non-US incorporated group members. Pursuant to the MTC Model,\textsuperscript{891} those members are required to adjust their Profit and Loss Statement, so that it conforms to the accounting principles generally accepted in the US. Further, adjustments shall also be made to the Profit and Loss Statement to bring it in line with tax accounting standards required by the State Tax Code. Income apportioned to each US State shall be translated in US Dollars. Finally, the Profit and Loss Statement as well as the FA

\textsuperscript{886} JR Hellerstein (1993) 415.
\textsuperscript{887} As regards tax base overlap, in particular, it should be mentioned that differences in the elements of tax bases on the two sides of the border may also lead to leaving items untaxed (i.e. double non-taxation).
\textsuperscript{888} Carlson & Galper 24.
\textsuperscript{889} ibid, Houghton 459.
\textsuperscript{890} Carlson & Galper 24-25.
\textsuperscript{891} s3.C ii.(b)(1)(A)-(E).
factors of each group member shall be translated into the currency in which the parent company maintains its books and records.

The above identified costs point to additional charges which place groups incorporating foreign-based members at a disadvantage, as compared to purely domestic ones. As mentioned in Section I above, though, worldwide combination was not held discriminatory by the US Supreme Court. Rather, it was found to be in conformity to the Foreign Commerce and Due Process Clauses. It is true that firms competing in the same industry may be subject to different levels of tax, depending on the geographical contours of the group. This should, however, be an expected outcome, as it reflects a rough approximation being inherent in tax base allocation through FA. 892

Part B: A Policy Choice for the EIM

I. Water’s edge for the EC

This Section discusses the rationale behind the policy choice of ‘water’s edge’ for defining the territorial scope of an EC-wide group. 893

892 Carlson & Galper 24-25; Houghton 459.
Worldwide combination in the US has largely been the outcome of constraints placed by the US Constitution. Briefly, unitary taxation was shaped to allow the US States to remain in conformity with the Commerce and Due Process Clauses when charging corporate taxes on activities across their borders. The global dimension of combined reporting has then been a necessity for computing unitary income, as this is, by nature, computed without reference to territorial frontiers. Rather, the maintenance of business integrity is the primary objective. Finally, the concession of a ‘water’s edge’ election has been an outcome of political pressure and not an effort to comply with principle.

The EIM has been structured to serve different principles and objectives, which are mainly derived from the EC Freedoms and the vision for a single market. The constitutional framework relevant to taxes is set by the Treaty of the European Community. In that context, limitations to Member States’ sovereignty in tax matters are placed by non-discrimination/non-restriction as well as the long-term objectives for a Single Market. As discussed earlier, there is a vital difference between the above two guiding principles. Infringement of the former provides legal ground to bring an action before the Court whereas the latter is not, as such, enforceable, as it is not contained in provisions with direct effect. New legislation normally aims at contributing to both the above principles.

The fact that worldwide combination gave rise to conflict and caused tension to US commercial relations suffices to justify the clear choice for ‘water’s edge’ in the EC.

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894 For a discussion of this, see in this chapter Part A.
896 See Chapter 1, Part A, Section II for a detailed analysis of how discrimination/restriction have been interpreted by the ECJ.
897 See Chapter 4, Part B, Section II, Title 1.
898 See Chapter 4, Part B, Section I.
899 Actions can be brought, before the national courts, against domestic law which is in breach of the EC Treaty. Standing shall be determined by virtue of the national rules of Administrative Procedure. In this case, the ECJ may have only indirect involvement through a reference for preliminary ruling (TEC art 234). In the same context, an alternative is to initiate infringement proceedings through an action which is brought directly before the ECJ. In that case, standing is only given to other Member States (TEC art 227) or the Commission (TEC art 226). See: Craig & De Búrea on preliminary rulings and enforcement actions against Member States.
Further, if this option is also evaluated by reference to principle, it appears that there are some points that justify it.

Pursuant to the conclusions reached on the entitlement to group membership in Chapter 6 above, the EC group taxation scheme should not incorporate primarily unitary features. Rather, the test shall be a technical ownership-oriented one. It follows that worldwide combination, originally devised to allow the accurate computation of the unitary tax base, may now remain absent from the system. A test of entitlement to group membership based on ownership is in principle compatible with ‘water’s edge’. As regards the risk of distortion or tax avoidance, due to the exclusion of third-country affiliates from the FA, it remains the same as under a worldwide group. This is because the above risks are directly related to the rules for determining group membership and not its geographical scope.

Another reason for giving EC group taxation a territorial scope limited to ‘water’s edge’ touches upon the fact that the EC is a lot less tolerant to double taxation than the US. The latter understands market efficiency to be primarily attached to tax competition and de-regulation rather than to harmonisation. As a result, double taxation is not regarded as a distorting factor which should necessarily be eliminated. By contrast, the EC seems to seek attainment of market efficiency through neutral treatment and harmonisation/approximation of laws. Thus, the elimination of double taxation is one of the long-term objectives envisaged for the EIM. A harmonised EC group taxation system would suffer severe double taxation if it accommodated a global dimension. Put another way, the EC share of group revenues, computed, in a global context, pursuant to EC common rules, would not

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900 See Chapter 6, Part B, Section II.
901 See Chapter 6, Part A.
902 Elimination of double taxation is one of the EC Treaty objectives for the EIM; see TEC art 293.
903 See Chapter 4, Part A.
904 Ibid.
905 In the legal framework of the EC, there is no constitutional principle equivalent to the Commerce or Due Process Clauses. Those are understood to reduce the occurrence of tax base overlap which causes double taxation. Read: Bittker 8-36 – 8-37; Moore 1450-1451.
cause any tax base overlap. However, taxpayers would, in effect, be charged double taxes, as a result of their tax liability in third countries which host group members.

II. Tests for Determining Participation in ‘water’s edge’

This section will discuss rules for determining which ‘affiliated entities’ should be treated as part of the ‘water’s edge’ consolidated group.

(i) The USA

In the US, there is no uniform State legislation on this. However, over the last years efforts have been made through the work of the Multistate Tax Commission (MTC) to achieve some amount of uniformity. In that context, the MTC Model deals with the ‘water’s edge’ election and provides a list of qualifying unitary members. The following entities have been identified as eligible for a ‘water’s edge’ election:

(i) those incorporated in the US or formed under the laws of any State, the D.C. or any territory or possession;
(ii) those with an average of FA factors within the US of 20 percent or more;
(iii) those of the specific corporate types of domestic international sales corporations or foreign sales or export trade corporations;
(iv) those not falling within any of the above categories should report their part of income derived from, or attributable to, US sources;

906 ‘Affiliated’ are those entities which fulfil the requirements for group membership but may not be admitted to the EC-wide group due to being incorporated/tax resident outside the contours of ‘water’s edge’.
907 Houghton 463 et seq.
909 s5.A. MTC Model.
(v) those that earn more than 20 percent of their revenues from business with other combined group members (i.e. revenues being, for the other group members, deductible business expenses);
(vi) Controlled Foreign Companies (CFCs);
(vii) those doing business in a tax haven (subject to exceptions).

The above delineation of ‘water’s edge’ entitlement points to a broad scope of the concept. The system goes beyond the territorial limit of the US. The purpose is to tackle tax avoidance or address issues that relate to the concept of a unitary business.

As regards tax avoidance, the aim is to discourage practices of artificial shifting of income beyond the ‘water’s edge’. To this end, provisions have been incorporated on CFCs and on affiliated entities doing business in tax havens. Further, point (v) above is an attempt to cancel possible benefits from driving business revenues out of ‘water’s edge’ through over-priced inter-company charges.

The scheme manifests an effort to keep distortion arising from fragmenting the unitary business low. In that sense, the presence, in the US, of the three FA factors (i.e. property, payroll and sales) at 20 percent or more, by average, is critical. The legislator’s thought has possibly been that those cases maintain so strong a link to the ‘water’s edge’ part of a unitary business that fragmentation would be very distorting. Tax avoidance may also be relevant here, as worldwide taxation in the US can be escaped through incorporation abroad.

By way of final comment on the MTC Model, no reference is made to PEs of non-US companies. This is a form of business presence which would probably be included into a ‘water’s edge’ election. Some comments can be made in connection with this. The provision incorporated is of a significantly broader construction, as it makes all US-source income part of ‘water’s edge’ tax base. This means that even a
limited business presence, not amounting to PE, becomes taxable at sub-national level in the US. The above option seems to derive from the nature of a unitary business. It namely is not defined by reference to corporate structure but, instead, through substantive criteria of business activity. Thus, the use of the concept of ‘source’ witnesses a material action of income generation. It may also be an indication that source taxation and FA, despite being different approaches to taxation, both serve similar needs. That is namely to trace revenue and tax it in the jurisdiction it is attached to, regardless of institutional framework (e.g. corporate form of revenue beneficiary).

(ii) The CCCTB Working Group of the European Commission

The Member States’ view on the entitlement of affiliated entities to participate in ‘water’s edge’ has been set out in certain of the CCCTB Working Group’s Documents. Those also contain the thinking of the European Commission.

In the analysis of ‘water’s edge’ so far completed by the Working Group, it appears that more attention has been given to clarifying which items of income should be part of the group tax base. Rules for determining which affiliated entities fall within ‘water’s edge’ may only be derived indirectly from the available working documents.

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910 This reflects the importance of business integrity in unitary taxation as well as the fact that a unitary definition of the group is by nature not limited by jurisdictional contours: Dexter 328; McIntyre (2004) 917 et seq.
912 Commission (EC), ‘The Territorial Scope of the CCCTB’ (Working Document) CCCTB\WP\026\doc, 17 February 2006 (hereinafter WG Doc on Territorial Scope); idem ‘An overview of the main issues that emerged at the first meeting of the subgroup on international aspects’ (Working Document) CCCTB\WP\029\doc, 2 March 2006 (hereinafter WG Doc 2 on Int’l Aspects); idem ‘An overview of the main issues that emerged at the second meeting of the subgroup on international aspects (SG 4)’ (Working Document) CCCTB\WP\033\doc, 24 May 2006 (hereinafter WG Doc 3 on Int’l Aspects); WG Doc 4 on Int’l Aspects; WG Doc 2 on Group Taxation.
Tax residence is the basic test in place, for the purpose of identifying, among affiliated entities, those being part of ‘water’s edge’. Both the above concepts are in principle connected with arm’s length separate accounting. One issue raised in this regard is whether Member States should be allowed to retain their existing definitions of tax residence and PE. The alternative would be to enact common rules. The aim would be to discourage distortion of investment decisions, due to disparities in definitions. Should common rules be found necessary, the OECD Model could be a good starting point.

No further elaboration on the above matters is contained in the CCCTB WG documents issued so far. As, however, this is an ongoing process, new input should be expected in this field.

(iii) Commentary

The main test for a ‘water’s edge’ election under the US MTC Model is the place of incorporation (and law of formation). In the EC Working Documents, there is use of the terms ‘residence’ and ‘PE’. The principal reason for this divergence probably relates to the US test for worldwide taxation, being nationality instead of tax residence. Domestic corporations in the US are those formed under the laws of one of the States, without any additional criterion applying.

Further, the US system is construed a lot more broadly than the EC one, as it attracts all revenues sourced within the US territory. By contrast, the EC Member States envisage laying down a minimum requirement of PE presence within the EIM.

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913 ibid paras 11 et seq.; WG Doc on Territorial Scope.
914 In considering a NAFTA-wide system of group taxation, McIntyre doubts about whether the concept of PE will continue to be a minimum physical presence for taxation: McIntyre (2004) 780.
915 WG Doc 2 on Int’l Aspects paras 16-17.
916 ibid paras 18-21.
917 ibid para 19.
Some of the tax avoidance provisions of the US MTC Model could be worth considering for the EC. In relation to CFCs and Tax Havens, it appears more practical to leave those cases out of the group system and allow the Member States to continue applying their domestic legislation. In particular, CFCs involve complex sets of rules in most cases. Making them part of a ‘water’s edge’ group would require that common rules be enacted, which would add complexity to the system. Indeed, the system would not suffer a compromise if CFC rules remained decentralised. The same is true for tax havens. This is because, in these areas, some amount of coordination of domestic practice already exists at global level through guidelines issued by international organisations.  

III. The ElM: Delineating the Contours of the Group

1. Identifying the Payers and Payees

Defining a ‘water’s edge’ group presupposes that the source and destination of inflows and outflows are respectively identified. The following payers or payees, as the case may be, are relevant:

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In connection with entities set up in a third country:\(^\text{920}\):

(i) affiliated entities, which do not take part in the ‘water’s edge’ group because, being resident in a third country, they fall outside its territorial scope;

(ii) third-country-located PEs of ‘water’s edge’ affiliated entities, insofar as the group taxation rules provide that the PEs should be incorporated into the group; and

(iii) third-country resident non-affiliated entities.

Within the EC:

(iv) non-affiliated entities resident anywhere in the EC;

(v) EC-located PEs of affiliated entities resident in a third country; and

(vi) if enhanced cooperation\(^\text{921}\) is in place, affiliated entities or PEs resident in Member States which do not participate in the EC group scheme.

2. Defining the Contours of EC-Wide Groups

A series of case studies will be set out below. Those have been shaped to demonstrate the complexities caused by flows of revenue into, or out of, the ‘water’s edge’ consolidated group.

In deciding on the territorial width of the group tax base, trading proceeds and passive income will be considered without distinction. In general, the challenges and complexities inherent in group incorporation or exclusion do not differ between business and non-business revenues. Passive income in the form of dividends, interest and royalties, when derived from non-affiliated entities resident in the EC, is relevant to delineating the intra-EC territorial contours of the group.\(^\text{922}\) In principle,

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\(^{920}\) This term is used for countries which are not EC Member States.


\(^{922}\) WG Doc 4 on Int’l Aspects para 10.
such intra-EC flows of revenue do not set forth issues in addition to those featuring in dealings with third countries. It cannot be excluded that, marginally, non-discrimination/non-restriction concerns under the EC Treaty Freedoms could arise but the scope is small.

(i) The Treatment of Third-Country Proceeds in the EC

The question arising in connection with the three scenarios above is how the proceeds paid to the parent entity (P) should be treated in the EC. It is presumed that the PE, being located in a third country, bears income tax at source. Further, dividends, interest and royalties, paid by a group subsidiary (S) or a non-affiliated entity (A), are also charged withholding tax.

The Option of Territoriality
Under a strictly ‘water’s edge’ scheme based on territoriality, third-country proceeds should be left out of the group tax base, since they are generated in a third country. In that case, each Member State will in principle apply its DTC with the third state and give relief by exemption or credit on a bilateral basis. This is also among the options set out by the CCCTB Working Documents. It is however of a broader relevance, as it can be applicable to any ‘water’s edge’ scheme of consolidated/pooled group tax base (notably, the HST). Retaining the principle that third-country proceeds will be kept outside the group tax base, a slightly different version of this has also been suggested by the CCCTB Working Group. That is, common rules are laid down by the Member States, for the purpose of providing relief for tax paid abroad. Hence, a decision will have to be reached on either exemption or credit.

**Incorporation in the Group Tax Base**

The second option is to incorporate proceeds generated in a third-country into the consolidated/pooled tax base. The idea behind this approach is that, irrespective of source, income earned by group members should be part of the group tax base.
Again, this matter has been elaborated upon by the CCCTB Working Group. Yet, it has a wider scope of application which makes it relevant to any group taxation system of a single ‘water’s edge’ base (incl. the HST\(^{929}\)). It follows that a decision should be reached by the Member States on a common method of relief. Uniform provisions will therefore be introduced for the elimination of double taxation. Those will take the form of either exemption or credit. It is also noteworthy that, under such a scheme, a re-negotiation of DTCs may be necessary, which appears the most serious drawback of the system.

If relief by exemption is given preference, all Member States will have to switch their laws to this.\(^{930}\) Indeed, the CCCTB Working Group has pointed out that common rules will have to be enacted to determine what constitutes foreign income.\(^{931}\) Otherwise, the system will be prone to severe risks of tax avoidance. Those would in principle consist of artificially shifting income out of the EC and into jurisdictions that apply low tax rates.\(^{932}\) Specifically in a Head Office – PE structure, a scheme of tax abuse could take the following form: the Head Office is set up in a Member State with a broad definition of foreign income and the PE in a third country applying a low tax rate.

In the case of relief by credit, the tax paid abroad will inevitably have to be apportioned across the group entities.\(^{933}\) Equally, the revenues already taxed in a third country will be added to the consolidated/pooled group tax base. As a result, rules for the apportionment of credit will have to be laid down.\(^{934}\) Significant complexity is expected to arise in implementing this, which could require a re-negotiation of DTCs. The main concern is that the state of source could challenge

\(^{930}\) HST (Lodin and Gammie) 24.
\(^{931}\) Most Member States employ credit relief. Switching from one system to the other has been referred to by the Member States as ‘a major (political) change in tax policy’; WG Doc 3 on Int’l Aspects para 6.
\(^{932}\) Exemption of non-NAFTA unitary income is also the choice favoured by McDaniel: see McDaniel (1994) 720; WG Doc on Territorial Scope para 22.
\(^{933}\) Ibid.
\(^{934}\) WG Doc on Territorial Scope para 15.
the method for apportioning credit at residence, bringing forth claims that this is in breach of the DTC in force. In addition, disputes would be likely to arise among Member States regarding the amount of apportioned credit allocated to each state. Finally, where relief consists of ordinary credit, additional complexities should be expected, as there is no obvious way of computing it.935

The allocation of income by FA is a system that functions independently of source/residence principles.936 In that sense, it does not accommodate residence-state relief methods (i.e. credit/exemption).937 In contrast, a scheme that allocates tax base shares by apportionment allows the prevention of double taxation through its own structure. Hence, no double taxation is generated to the extent that: (i) common rules apply to computation of the group tax base; and (ii) a uniform formula is operated across all jurisdictions with a right to tax.938

A clash is inevitable where the FA meets traditional international tax principles.939 In the US, the allocation of combined unitary income by apportionment is applied in connection with taxation at sub-national level. Further, DTC obligations are settled by the federal government, as it is only federal-level taxes that may contain a foreign element.940 The above structure is far from the regulatory framework which shapes direct taxation in the EC. Namely, tax is exclusively charged by the Member States.941 No central authority at European level is allowed to interfere with this. It is therefore the Member States that should provide relief for double taxation through their DTC network. Meanwhile, under an EC-wide group taxation scheme, these

935 ibid para 17.
936 McIntyre (1994) (numbering is not available in the electronic version).
938 McLure and Weiner 253; (indirectly) Moore 1450.
939 The problem has also been identified in connection with passive income in PR McDaniel, 'Formulary Taxation in the North American Free Trade Zone' (1993-4) 49 Tax Law Review 691, 720 (hereinafter McDaniel (1994)); for a view which does not take account of the DTC aspect, see Pomp 800-801.
941 In confirmation of the above, the following statement is present in the vast majority of ECJ decisions in direct taxation: "... it should be noted that, according to settled case-law, although direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with Community law ...".
states will be taxed on an apportioned share of the ‘water’s edge’ base. Inevitably, these two mechanisms (i.e. DTCs and FA) clash.

It is hence doubtful whether third-country proceeds can be part of the consolidated/pooled tax base without going through a process of DTC renegotiation. Still though, mechanisms for relief in the US and UK tax systems could possibly provide an opportunity to apportion credit without amending tax treaties.

The UK facility gives relief for underlying tax paid in the state of source where dividends are distributed into the UK on or after 21st March 2000. The payer should be a consolidated group of companies which is treated as a single entity for double tax relief purposes. The scheme involves apportioning the tax liability of the consolidated group for the purpose of calculating the tax share of the entity which made the dividend distribution. Relief by credit is then given in the UK on that basis. The UK Finance Act (diagram 2 below) involves a reversed set of facts to that of diagrams 1(a), (b) and (c):

2. Relief in the UK for Underlying Tax Paid at Source

It is clear that a single DTC (i.e. UK and source state) is applicable. A single entity (S4) is under the obligation to give relief. However, the amount of underlying tax borne by the payer (S2) can only be computed by FA, since the group under P is treated as a single entity.

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942 FA 2000 s803A.
943 A Munro, Tolley’s Double Taxation Relief (7th edn Lexis Nexis Tolley) 148.
In the US, apportionment is applied in a similar context. The purpose is to compute the tax share corresponding to a US-resident entity which has been subjected to tax abroad, as part of a consolidated group. Relief is then given in the US for taxes paid abroad. This is a common situation, where a certain entity is transparent under foreign law (i.e. law of the group’s state) whilst it qualifies as a company in the US.

The above bear similarities to the settings of diagrams 1(a), (b) and (c) involving a group in the EC. The combined facts are shown in diagram 3 below. The group is now on the ‘side’ which should give relief. So, it is the credit that has to be apportioned and not the tax payable in the state of source. DTCs will typically continue to apply at a bilateral level. In the diagram below, the applicable DTCs should be: (i) third country – Member State of P in relation to dividends, interest and royalties; and (ii) third country – Member State of S3 for PE remittances. The apportionment of credit will bring together the entire group. Namely, all Member States hosting (‘water’s edge’) group entities (i.e. P, S1, S2, S3) will be involved in apportioning the credit for taxes paid in the third country(-ies).

The above scheme should not cause complexity with Member States’ external network of DTCs (i.e. DTCs with third countries). The relations remain bilateral. Further, commitment to give relief, as undertaken under the DTC vis-à-vis the third

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country, is complied with, insofar as credit is actually given. The precise way of meeting DTC obligations is left to the contracting parties.

(ii) The Treatment of Proceeds Earned within the EC

The transactions shown in diagrams 4(b) and (c) above do not create problems from an EC perspective. Group members' taxable income (i.e. P, S1 and S2) will be consolidated and allocated by FA. Apart from that, payments of dividends, interest and royalties involve specific amounts and derive from an identifiable payer (i.e. S2). So, that should allow relief for withholding tax at source (and possibly for underlying tax on dividends) to be given without problems in the state of residence. It is irrelevant whether the recipient is affiliated (S3) or not (A). In the event that the third country gives relief for underlying tax paid at source, it may provide for apportioning the group tax base. 945

945 See above in this chapter Part B, Section III, Title 2.(1) for the UK system.
PE income is earned within the territory of ‘water’s edge’ (diagram 4(a)). The question is whether the PE’s taxable income should be consolidated/pooled with the parent company’s (P) revenues, given that the Head Office (S) is tax resident in a third country.  

The starting point would probably be to argue that PE income should be part of the group tax base, as it is itself located within the territorial scope of the ‘water’s edge’ group. Sharing affiliation with the parent entity, the PE is most likely to be an integral part of the group’s business in the EC.  

So, from a point of view of substance, making the PE’s revenues part of the consolidated/pooled tax base appears to also contribute to a more accurate result of the apportionment. In contrast, exclusion would encourage the creation of tax avoidance schemes consisting of shifting income, otherwise generated within the ‘water’s edge’ group, out of the group tax base.  

If the PE is kept outside the group tax base, its tax liability at source will be determined pursuant to domestic law and the provisions of the applicable DTC (if one is in force). All Member States apply the arm’s length principle when calculating profits of PEs. Further, most DTCs have been drafted in line with the OECD Model and, as a result, incorporate an equivalent to Article 7 OECD Model on the attribution of profit to PEs. The provision is currently under review by the OECD. The new approach which attracted members’ support at the OECD is referred to as the ‘Authorised OECD Approach’ (AOA). The position taken is

\[946\] WG Doc on Territorial Scope para 30.  
\[947\] ibid para 31.  
\[948\] This derives from the rationale behind unitary combined reporting. The membership of the group, and thus subjection to apportionment by formula, is determined by reference to business integrity rather than the corporate structure. See also Chapter 6, Part A, Section III.  
\[949\] WG Doc on Territorial Scope para 31.  
\[951\] WG Doc 4 on Int’l Aspects para 14.  
\[953\] ibid para 44.
that, in computing tax bases, PEs and Head Offices should be treated as completely separate entities.\footnote{ibid para 14: ‘... the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with the rest of the enterprise, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the “arm’s length principle” discussed in the commentary on Article 9’.}

Making PE income a component of the consolidated/pooled group tax base raises problems due to the ‘uneasy’ interaction between the FA and DTCs.

If no DTC is in force between the Member State of the PE’s location and the country of the Head Office’s residence, no complexity arises. Namely, the revenues of the PE will become part of the group tax base shared among the eligible Member States by apportionment. In this context, double taxation is impossible to eliminate but its occurrence does not cause illegitimacies.

More parameters should be taken into account for legitimacy if a DTC applies. As mentioned, the PE’s tax liability at source should typically be computed pursuant to domestic law and the DTC possibly in force. Arm’s length is normally the guiding principle in this process. Yet, once the PE becomes part of a group of consolidation/pooling, its taxable share will have to be computed through FA, as a constituent element of the group tax base.\footnote{It should be clarified that, even under such a scheme, arm’s length is still typically used in computing the PE’s tax results which are then consolidated/pooled to create the group tax base.} Considering that the majority of DTCs contain rules for a computation of the tax base on the arm’s length standard, the allocation of taxable shares by FA would infringe DTC obligations. Thus, whenever the amount of tax due through FA is higher than the arm’s length liability, the state of residence of the Head Office would be likely to object. Being a third country, this is not bound by EC Law. More specifically, the claim would most probably be for a breach of contractual obligations undertaken under a DTC. That brings forth the need for DTC re-negotiation once again.
It seems that, unless the longer-term objective of DTC renegotiation is accomplished, arm’s length will continue to be an indispensable element of the system. That allows separate accounting concerns to survive, which undermines some of the key benefits expected to be derived from the envisaged EC scheme.\textsuperscript{955} It further leads to increased administrative costs, rendering the system less efficient. It appears, however, that no better workable solution can be devised for the EC, considering the current state of embryonic integration in direct taxes.\textsuperscript{956}

(iii) PE in the Position of Parent Entity

Despite bearing final tax liability outside the ‘water’s edge’ group, a PE may still be allowed to occupy the position of a group’s parent. Its status, from a tax point of view, is identical to that under diagram 4(a). Thus, the tax liability of the parent entity (P) in the Member State of PE’s location will need to be calculated under both arm’s length and group taxation rules. Further, the tax due by the PE in the state of source will have to be determined as specified under Title (ii) above. Responsibilities specifically attached to the parent entity under an EC group taxation scheme involve the computation of a common tax base and its allocation by FA. Establishment through a PE should not be an impediment to carrying out those tasks.

\textsuperscript{955} This primarily refers to transfer pricing formalities. Under an EC-wide group taxation system, those formalities and costs are specifically targeted through FA.

\textsuperscript{956} For an outline of what has been attained through positive integration in the EC, see earlier in this thesis Chapter 2.
(iv) The Parent Entity in a Third Country

The question is whether the EC part of the group can be run by any of the two subsidiaries (S1 or S2). This means that one of the two entities would undertake to register the group and carry out the apportionment procedure.

In the UK loss relief system, transfers are allowed between sister companies. Yet, the UK group taxation scheme does not accommodate consolidation/pooling. Indeed, under a consolidated structure, the situation is not comparable to that of loss relief, since the latter does not involve the computation of a single group tax base. Allowing the creation of a group without, in practice, a parent entity could distort the accuracy of profit allocation in a landscape of consolidation/pooling. It is all the more so if one considers that the structure is not meant to endorse unitary principles, which by nature retain some minimum business integrity.

(v) Third-Country Subsidiary Indirectly Held by a ‘water’s edge’ Entity

Rupal in IFA Cahiers 693.
This is a structure which could give S2 entitlement to group membership. The decision is purely a matter of policy choice. The jurisprudence of the ECJ on the Free Movement of Capital and third countries has made it certain that no aspect of the Freedom of Establishment extends to third states. There is therefore no ground for sustaining infringement of the Treaties if subsidiary S2 is excluded from the group. However, were S2 indirectly held through an EC-resident entity, the precedent of ICI would create an obligation to include S2 in the group.

Conclusion

In the current shape of the EIM, a group taxation system of consolidated and apportioned common tax base cannot be implemented without severe drawbacks. Complexity arises in the following fields:

(A) Part of the advantages expected to be derived from saving transfer pricing compliance costs will be cancelled. The above risks defeating one of the key

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958 For a comprehensive survey of the jurisprudence on the Freedoms and third countries, see: Chapter I, Part A, Section II, Title (iv).
959 See Chapter I, Part B, Section II, Title A.
960 Staff Paper 255 et seq.
objectives of the EC group taxation project. Thus, tackling transfer pricing compliance obligations has been one of the main reasons for justifying the EC group taxation initiative.\textsuperscript{961} If arm’s length separate accounting retains a presence in the scheme, high transfer pricing costs will persist.

(B) The network of DTCs between the Member States and Third Countries clashes with the intra-EC allocation of profit through FA.\textsuperscript{962}

DTCs are concluded in line with international tax principles. That is, they allow relief (by exemption or credit) in the state of residence for tax paid in the state of source.\textsuperscript{963} Further, the attribution of income within Head Office – PE dealings\textsuperscript{964} or parent – subsidiary company transactions\textsuperscript{965} is checked for compliance on the arm’s length standard. By contrast, a group taxation system accommodating FA does not provide for relief at residence. Indeed, the concepts of residence and source are not even relevant to the scheme.\textsuperscript{966}

Where relief should be given within ‘water’s edge’ for tax paid in a third country by a PE (or for withholding tax on inflows of dividends, interest or royalties), some solution can be worked out. It has thus been shown that certain provisions in the DTC systems of the UK and the US could offer a solution.

On the other hand, the system appears deadlocked where income of a PE held by a third-country entity is taxed within ‘water’s edge’ as part of the group tax base. In that case, approval of the PE’s tax liability at source exclusively depends on the approval of the state of the Head Office.

\textsuperscript{961} Ibid.
\textsuperscript{962} WG Doc 2 on Int’l Aspects paras 7 & 8.
\textsuperscript{963} OECD Model arts 23A & 23B.
\textsuperscript{964} Ibid art 7(2).
\textsuperscript{965} Ibid art 9(1); Transfer Pricing Guidelines I-3 – I-6 (mainly).
\textsuperscript{966} McIntyre (1994) (numbering is not available in the electronic version).
Overall, the discussion on ‘water’s edge’ demonstrates that the EC is still inadequately integrated to accommodate an EC-wide group taxation system. DTC re-negotiation could offer a number of solutions, especially if coupled with an EU Model DTC. Considering, though, that this would require a coordinated effort by the Member States, there seems to be little prospect for bringing such an attempt into fruition in the short term. In addition, the process can be extremely time-consuming anyway.

It seems that no EC-wide group taxation project can be implemented properly under the current state of development of the EIM. FA is a system to apply internally within highly integrated markets. It is not made to accommodate international elements, unless those apply globally. In the US, international commitments are dealt with at federal level, on the basis of international tax principles of source/residence. It is also at this level that DTCs are negotiated. Yet, in the EIM, competence in direct taxes conceded to the EC is next to non-existent. Therefore, Member States deal with tax matters at all three levels: international, EC and domestic. In such a context, implementation of FA would convert a profit allocation mechanism, aimed at internal application, into an instrument of intergovernmental nature. This is, by definition, a flawed approach, which cannot go very far.

The complexities highlighted above do not render an EC-wide consolidated group impossible to operate. It seems, though, that the system will inevitably suffer significant drawbacks if it has to be implemented in the current setting of the EIM.

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967 In contrast, combined reporting, applying at sub-federal level, operates independently of DTCs, which prevents clashes.
968 The Community has legislated only in few areas of relevance to direct taxation: P-S Directive; I & R Directive; Savings Directive; Exchange of Information Directive; Mutual Assistance Directive.
9. FORMULARY APPORTIONMENT

Introduction

The allocation of the group tax base by Formulary Apportionment (FA) is one of the key elements attached to the initiatives for an EC-wide group taxation system. This is a mechanism used in determining the amount of the group tax base taxable by each of the eligible Member States. It is an alternative to income attributed by separate accounting at arm's length. That has so far been the international norm proposed by the OECD Model.\textsuperscript{969}

FA is generally treated as suitable for allocating entitlement to tax within highly integrated markets, which allows it to apply at sub-national level. The method was devised in the US and evolved in conjunction with unitary combination. In the absence of group taxation, FA may still be applied to allocate the taxing entitlement over a single entity's tax base to more than one jurisdiction. This is the case in Canada and Switzerland. Namely, a share of an entity's tax base is allocated to those provinces or cantons entitled to taxing it. Further, it has been discussed whether a unitary definition of the group is a requirement for apportionment by formula.\textsuperscript{970} It was also shown that FA presupposes the existence of a single group tax base.\textsuperscript{971} That implies that schemes such as those of loss-relief or profit contribution, in which entities retain full integrity, cannot accommodate FA.

\textsuperscript{969} Houghton 457-458: in the 1930s, the League of Nations concluded that FA should be rejected in favour of arm's length separate accounting.
\textsuperscript{970} See at Chapter 6, Part B, Section 1.
\textsuperscript{971} See at Chapter 7, Part A, Section II, Title (i).
In the framework of an EC-wide group taxation system, FA has always been the envisaged method for allocating the group tax base. It lies at the heart of all proposed systems, since it fulfils a number of functions and objectives, such as eliminating transfer pricing compliance obligations.972

This thesis is not meant to incorporate a detailed analysis on the economics of the formula. Rather, it focuses on discussing the core structures of an EC group taxation system from a legal perspective. The aim will be to identify and discuss those elements of the FA relevant to the EIM.

Part A: Methods of Allocating Profits within a Corporate Group: Arm’s Length Separate Accounting versus FA

Separate accounting has always been the international norm when it comes to computing tax liability. It is also the method put forward by the OECD Model Tax Convention in connection with profit allocation between associate companies973 and in Head Office – PE dealings.974 The OECD Transfer Pricing guidelines contain a comparison between the arm’s length principle and FA.975 More specifically, the issue considered is the implementation of a worldwide apportionment and the position taken is clearly against any such prospect. The specific arguments put forward will be considered later. Generally speaking, part of the discussion deals with deficiencies inherent in FA. Another aim is to demonstrate that FA could only

972 Staff Paper 373-378; HST (Lodin and Gammie) 24.
973 OECD Model DTC art 9.
974 Ibid art 7.
be implemented within highly integrated markets, which renders it an inappropriate choice for a global system.

In the early 1990s, the Ruding Report rejected the prospect of applying FA to EC integration initiatives in the field of corporation taxes. It was noted that: ‘...allocation is suitable only if States have reached an advanced degree of integration, such as common currency, common company law, common accountancy standards and common expertise in tax administrations...’ 976 A decade later, the EC approach to FA appears to have changed. The proposed comprehensive approaches to group taxation 977 have endorsed FA as a necessary element for the allocation of the group tax base.

Below, an attempt will be made to draw a comparison between arm’s length separate accounting and FA. The aim should be to pinpoint advantages and drawbacks of the two methods and to further demonstrate how market integration may set forth different requirements.

(i) Separate Accounting

Income is attributed to each entity or branch, primarily on the basis of their own accounts. The system is primarily based on traditional source and residence rules used in allocating tax jurisdiction within a cross-border framework.

In cross-border transactions between affiliated entities, transfer pricing rules are normally in place to check compliance with arm’s length standards. That is an amount corresponding to the price of the transaction had the parties been unrelated.

In this process, transactions between affiliated entities or dealings in a PE – Head


977 Staff Paper 370 et seq.
Office context are often found not to conform to arm’s length standards. Adjustments are then carried out to bring pricing to the level of arm’s length.

(ii) Formulary Apportionment

FA is an alternative to separate accounting. It is another method for allocating the tax base to eligible taxing jurisdictions.978 In determining each taxable portion, the ‘factors’ (normally, payroll, property and sales) play a key part. Thus, the heavier their weight in a certain tax jurisdiction or entity, the bigger the portion of tax base which they attract. FA is normally found in computing corporate taxes at sub-federal level. This is a system which fits structures of highly integrated markets better than separate accounting at arm’s length. The reasons will be discussed later. By contrast, the FA cannot in principle accommodate international elements.979 This is because the allocation of revenues by apportionment is not compatible with source/residence rules.980 In a global framework, those regulate, through DTCs, relations between countries.

Worldwide, there is no uniform formula. Diversity may also exist within the same country. This is partly the case in the US and Switzerland, whereas in Canada, the provinces have agreed on uniformity.981 In addition, the so-called ‘Massachusetts Formula’, a three-factor equally-weighted formula, is used in the US as a common starting point subject to adjustments by each State. Canada employs a two-factor formula based on sales and payroll. It also is not uncommon that different weight is assigned to the factors of the formula, for the purpose of achieving a specific outcome. For instance, some US States double the weight of sales to enhance inward

978 In the context of groups, FA may consist of two levels: (i) apportionment to allocate the group tax base to eligible taxing jurisdictions; and (ii) within each jurisdiction, apportionment of the allocated share to eligible entities. This is how FA has been implemented in the US.
979 Transfer Pricing Guidelines III-20.
980 See Chapter 8.
981 See Chapter 3.
investment. As sales are taxed at destination, placing double weight on sales should give an incentive for setting up manufacturing activities domestically.

FA does not require that a group taxation system is in place. It may also be used in apportioning the tax base of a single entity incurring tax liability in more than one jurisdiction. This is the case in Canada and Switzerland at provincial and cantonal level respectively.

In the context of groups, apportionment is applied to allocate a consolidated/pooled group tax base. Therefore, the existence of a single tax base is a prerequisite for apportionment. Yet, as said in chapter 7, consolidation does not always require attribution of income by FA. However, source/residence separate accounting rules are possible only in a limited number of cases. This is when consolidation/pooling is performed for the purpose of computing the parent entity’s tax liability, whereas the subsidiaries have been charged taxes on an individual basis. Where the group is defined pursuant to unitary business tests, FA is the only possible method for profit allocation. This is a natural outcome, as unitary tests for group definition and the FA were developed in the US to meet similar needs. As a result, the two concepts have grown to be inextricably linked.

(iii) A Comparison

There is a main conceptual difference in the way that FA and arm’s length separate accounting treat taxable revenues. The former looks at the common business itself, rather than the branches or group entities. By contrast, the latter focuses on the

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984 This is a demonstration of the close ties between FA and a group defined according to the principles of unitary taxation. As discussed in chapter 6, a unitary definition of group would be the optimal choice to combine with allocation of profit by FA. However, practical drawbacks as well as the tradition of national group taxation systems in Europe suggest that preference should be given to an ownership-based approach. See also McIntyre (2004) 933-934.
constituent parts of the business, being the means for earning income. Under the FA, taxes are levied on 'some portion of each dollar within each taxing jurisdiction in which apportionment factors are located'. An immediate consequence of this is to allocate a portion of the taxable base even to loss-making countries. Thus, the objective is to attain fairness over a reasonable period of time. The tax base in each jurisdiction cannot be proportional to the factors located therein on each separate occasion. In that sense, the advantage given to one jurisdiction over another is occasional and by no means predictable.

In an international context of limited economic integration, separate accounting can lead to satisfactory solutions. Namely, where there is limited sharing of corporate resources in a group, the concepts of source and residence are easier to identify. This is mainly because corporate entities retain their integrity as well as a significant amount of independence. In addition, FA is not a suitable system to apply internationally. Below, it will be shown that large disparities among national systems cannot be accommodated, without arbitrary results, within a scheme of apportionment. Thus, FA provides better solutions than separate accounting when it comes to highly integrated MNE structures. Further, a fair result can only be achieved if the scheme is implemented within a regulatory framework of some uniformity. It is often the case that, in federal-type markets, one comes across both the above conditions.

(a) Allocation of taxable profit within MNEs

Business organisation in MNEs is often highly integrated, which brings forth a number of implications in calculating the tax liability of individual group entities.

985 Ibid 933.
987 McIntyre (2004) 917 et seq.
989 This is also the outcome of the discussion in Transfer Pricing Guidelines.
990 McIntyre (1994) (numbering not available in the electronic version).
The bottom line appears to be that separate accounting cannot meet the challenges. It is a system mainly designed to compute tax liability in relations among unrelated entities.

A first issue is the risk of tax avoidance through income shifting. Separate accounting cannot always effectively deal with tax planning techniques of shifting accounting profits towards low-tax jurisdictions. Within a context of increased capital mobility, such as an MNE within an integrated market, the above risk of manipulation is even more increased. For instance, loans and intellectual property rights may be transferred to a country with a low business tax rate. The country may also have a good DTC network with jurisdictions in which manufacturing entities of the group are located. Under such a structure, withholding tax at source will most probably remain low or nil (depending on the applicable tax treaty provisions). At the same time, a considerable amount of group revenues will be generated in a low-tax jurisdiction.

A widely-identified drawback of separate accounting, related to the above, is the administrative formalities attached to transfer pricing rules. Compliance involves a costly process of time-consuming submission of detailed documentation before the tax authorities. The aim is to provide evidence that arm’s length standards have been observed in transactions between associated companies or in Head Office – PE dealings.

In addition to the above, arm’s length pricing can be very difficult to work out in the context of intra-group transactions, as there is often no Comparable Uncontrolled

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992 Staff Paper 262; Transfer Pricing Guidelines III-20 and III-21; elimination of transferrid pricing compliance obligations has been cited as one of the main objectives pursued by the European Commission’s initiatives for an EC-wide group taxation system.
993 OECD Model DTC art 9(1); Transfer Pricing Guidelines I-3 – I-6 (mainly).
994 OECD Model DTC art 7(2).
Price (CUP) for certain goods or services.\textsuperscript{995} This is a common complexity which becomes more frequent and intense within global MNEs. Those produce highly specialised products, being worldwide brand names, which are exclusively identified with a specific MNE. Under such circumstances, fixing a CUP often turns out to be an unsuccessful exercise.

The identification of the source of revenues is a key process in attributing income to taxable entities under separate accounting. However, tests of source do not often lead to satisfactory results. Especially in a cross-border context, it is often impossible to trace an unambiguous geographical location.\textsuperscript{996} That is because more than one factor may be important in determining the source of income. For instance, a major decision is whether source should be attached to the location where income originates or where the profit is obtained.\textsuperscript{997} When it comes to MNEs, source can be very hard to identify, as income is likely to have important links to more than one country.\textsuperscript{998} Further, the capital of MNEs, mainly consisting of intangibles, cannot easily be attributed to a specific geographical location.\textsuperscript{999}

Another field in which separate accounting often proves deficient is in separating the profit attributable to each group member. Allocation of profit through arm's length may lead to an arbitrary procedure,\textsuperscript{1000} which fails to reflect the MNEs' economic realities.\textsuperscript{1001} In practice, this means that shared values and costs creating economies of scale and scope may often not be reflected in the group's tax liability.

Allocation of profit by FA provides solutions to the above problems, specifically centred on MNEs. The need to apply transfer pricing rules and work out price

\textsuperscript{996} McIntyre (2004) 926.
\textsuperscript{997} Ibid.
\textsuperscript{998} Ibid 928.
\textsuperscript{999} Ibid 929.
\textsuperscript{1000} Musgrave (1984) 236.
comparables (CUP) will be limited. Thus, the group’s income is consolidated/pooled into a single base of which shares are then allocated to eligible States and entities on the basis of substantive elements (‘factors’). As regards the possibility of revenue shifting, it cannot be entirely eliminated under that scheme either. However, anti-avoidance rules should now aim at different practices. Namely, income shifting may be attempted here through a manipulation of the factors. The FA places no requirement for identifying a certain geographical location as the source of income. Rather, revenue is attached to a jurisdiction according to the factors’ tests.

Finally, the allocation of revenues by FA allows a more accurate computation of each affiliated entity’s contribution to the overall profit of the MNE group. It should be pointed out, though, that a business’ economic realities may still not be reflected accurately in the group entities’ tax liabilities. Unless the group is defined in line with unitary principles, the above is a real risk.

(b) The requirement for an integrated internal market

FA may only be operative within highly integrated markets. It thus cannot be applied internationally, unless a global scheme were launched – a rather unlikely prospect. This is mainly because a certain amount of uniformity is required within the regulatory framework which accommodates the formula. For instance, a common currency as well as tax and accounting rules appear necessary. Otherwise, compliance may end up being more burdensome than transfer pricing documentation obligations. Further, as discussed in chapter 8 on ‘water’s edge’, FA creates an interaction of incompatibility with separate accounting at arm’s length. Considering that the latter is the norm in states’ bilateral fiscal relations, FA is, in principle, excluded from the international context.

1003 Transfer Pricing Guidelines III-20.
An accurate outcome of FA cannot be sustained where sharp disparities mark the jurisdictions eligible for a share of the tax base. Integrated markets usually manifest a certain amount of coordination. FA does not take specific account of differences in profitability, as the aim is to produce a fair final outcome reflective of business economic realities. The example of railways in the US highlights this thinking. Namely, even the least busy parts of the railway are treated as contributing to the value of the overall business. A large part of such value is derived from the actual fact of connecting, by railway, the starting and destination points. In the above set of facts, a profitability difference does not compromise accuracy. The outcome is evaluated at the level of the entire business rather than by looking at each bit separately. However, had market integration been absent, the result of FA would have been arbitrary due to favouring higher profitability units. The above is also in close ties to a unitary definition of the group. As acknowledged in chapter 6, ownership tests for entitlement to group membership risk distorting the FA if the lines drawn among affiliates are artificial.

Part B: FA in the US, Canada, Switzerland and Germany

In discussing the FA in the EC, reference should be made to the above four countries. All of them being organised in federal-type structures accommodate systems of apportionment in allocating the tax base at sub-federal level. Canada, Switzerland and Germany apply FA in the context of a single entity, rather than in groups. This is because there is no group taxation at regional level (i.e. provinces,
cantons and Länder). The Canadian and Swiss systems, in particular, do not contain any group taxation at all. Germany allows pooling (Organschaft) at federal level. It follows that, inevitably, the focus of discussion in this chapter will be on the US, which operates an elaborate system of sub-national group taxation (known as 'unitary taxation' or 'combined reporting').

The analysis below is not aimed to be a comprehensive survey of FA in the countries mentioned. It is meant to contain a short historical survey of FA’s development as well as a discussion of its key elements, being of potential interest to the EC.

I. The United States of America

FA developed in the US as part of the concept of unitary taxation. It therefore evolved in conjunction with the definition of a unitary business and within the legal framework of the Due Process and Commerce Clauses. In the mid- to late-1800s, FA was used in calculating the value of railroads. At the time, application was within the contours of a single firm. Since the advent of combined reporting, it has been structured to apply at two tiers. At first, it is used to apportion the combined base among eligible States and then, within each State, to allocate shares to eligible entities. In 1911, FA was first connected to corporation tax, which was then levied at the States’ level for the first time. The development took place in Wisconsin and FA employed three factors: property, the cost of manufacture and sales. In 1920, the US Supreme Court found constitutional the FA for the

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1008 See earlier in this thesis on unitary taxation: Chapter 6, Part A, Section III.
1009 Ibid.
1010 McIntyre 917 et seq.
distribution of net income of a manufacturing corporation across States. The early formulae incorporated numerous factors.

As early as the 1930s, though, some amount of uniformity in FA factors had already been achieved. Thus, the so-called ‘Massachusetts’ formula of three equally-weighted factors gradually became the norm. In 1933, the ‘Massachusetts’ formula was put forward by the National Tax Association (NTA) as a recommended choice for apportionment. Further, the Uniform Division for Income Tax Purposes Act (UDITPA) proposed the three-factor formula in its common definitions in 1957.

Attempts to harmonise formulae continued on the initiative of Congress. In 1959, the ‘Willis Committee’ was created with the task to document States’ corporate tax practices. The report that came out proposed the adoption of a two-factor formula based on property and payroll. Congress followed up on the work of the Willis Committee but was never successful in its efforts to pass Bills laying down uniformity measures. Development came from the States themselves which, in 1967, created the Multistate Tax Commission (MTC). The MTC devised the Multistate Tax Compact, an instrument of soft law which incorporated the income division rules of UDITPA. The States have broadly followed this ever since. The US Supreme Court has acknowledged the risk of overlapping tax bases, due to the absence of uniformity of factors among the States. It however pointed out that only Congress can decide on whether uniform rules should be enacted.

UDITPA endorsed the ‘Massachusetts’ Formula. Equal weight of the three factors creates a potential for wider entitlement to tax to the State of manufacture. Property and payroll carry a weight amounting to two thirds of FA. It follows that an increase

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1012 Underwood Typewriter Co. v Chamberlain 254 U.S. 113 S.Ct. 45 (1920).
1015 Ibid 12; the UDITPA is a Model Act aimed at providing a framework of uniform regulation for the States.
1018 Moorman.
of equal value in investment in the State of manufacture and in sales in the State of
destination does not impact equally on the taxing entitlement. Namely, the State of
manufacture impacts, through property and payroll, on FA twice as strongly as sales
in the marketing State.

UDITPA contains definitions of the three factors. A short outline is given below. 1019

Property comprises real estate and tangibles owned or rented and used in the eligible
State. Values are reported at historical cost, as adjusted to account for additions and
enhancements. Depreciation is not taken account of, to prevent fragmentation of
regulation among the States eligible for part of the tax base. The treatment of
intangibles, being excluded from the factors, has raised severe debate. 1020 The main
question to be answered is, to what extent, given the exclusion, the result of FA
remains accurate. Business' modus operandi is nowadays far from the structure of a
traditional manufacturing company. In this context, trade in intangibles has hugely
increased, which could challenge the choice to exclude such income from FA.

Payroll involves the total amounts paid for compensation to employees. A
commission paid to independent contractors should clearly be left out of FA.

Sales include all gross receipts, not specifically allocated as non-business
income, 1021 after deducting returns, discounts and allowances. The factor does not
only deal with goods but also with supplies of services, rentals, royalties and
business operations. Sales are taxed at destination. Briefly, in sales of tangible
property, the point of taxation shall be where the purchaser is located. When it
comes to other than tangibles, the aim is to identify where the income-producing
activity is performed. If that is impossible, the relevant amounts of business income
are 'thrown-out' of FA.

and Policy in International Business 1133, 1147-1152 (hereinafter Christensen); Genetelli 15-16.
1020 JR Hellerstein (1993) 415-416: the debate will be discussed in Part C of this chapter.
The current situation still reflects the tendency of the 1980s, which consisted of increasing the weight given to the sales/gross receipts factor. Under the most common structure, sales are double weighted. The rationale behind this has been to provide an incentive for inward investment by reducing the overall weight of the State’s taxing entitlement. According to data referring to the state of affairs on 1st January 2007, twenty US States apply, exclusively or partly, a double-weighted sales factor in FA. Further, only fourteen have, exclusively or partly, retained the ‘Massachusetts’ rule.\(^{1022}\)

An interesting conclusion can be derived from comparing current year data to that of 2004.\(^{1023}\) The tendency to increase the weight awarded to sales appears to have gathered impetus all this time and remains alive. Over the last three years, an obvious trend can be detected to adopt FA structures exclusively based on sales. More specifically, three States (i.e. Illinois, Iowa and Nebraska) exclusively applied a single-factor sales FA on 1st January 2004. Three years later,\(^{1024}\) the number has risen to six (i.e. Louisiana, Oregon and Texas) with another three States (i.e. Georgia, New York and Wisconsin) due to join in 2008 and a fourth (i.e. Minnesota) in 2013.

In *Moorman*, the US Supreme Court ruled that the single-factor FA of Iowa, exclusively based on sales, did not violate the Due Process and Commerce Clauses. It was found that it is adequate to sustain a ‘minimal connection’ between interstate activities and the taxing State.

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\(^{1021}\) Genetelli 27.


\(^{1024}\) State Apportionment Formulae 2007.
II. Canada

It has been explained in chapter 3 how Canadian sub-federal corporation taxes developed into a structure of uniformity, allowing divergence only in connection with tax rates. Apportionment in Canada applies for the purpose of allocating shares of a single entity's tax base to eligible taxing provinces. There is no group taxation to accommodate consolidation or pooling.

Coordination between the two levels of government (i.e. federal government and the provinces) came after World War I. In allocating taxing entitlement, current uniformity has largely been the result of the so-called Wartime Tax Agreements concluded over World War II. The amount of coordination reached then, by levying tax at federal level, was retained to some extent after the War and throughout the second half of the twentieth century.

The Canadian system of allocating taxing entitlement to provinces is not likely to cause double taxation. Thus, the existence of uniformity in both the tax base and the formula should in principle prevent overlap. Further, FA in Canada draws a balance between the manufacturing and marketing provinces, since it allocates equal weight to payroll and gross receipts. This certainly does not enhance competition and reduces the scope of tax planning practices. Yet, competition is maintained in the system through other mechanisms. Tax rate divergence, being a result of allowing rates to be determined individually by the provinces, contributes to this.

III. Switzerland


Switzerland does not accommodate a group taxation system. As a result, the allocation of taxable profit to the cantons is carried out within the contours of a single entity.

Despite the prohibition of double taxation contained in the Federal Constitution, there is typically no uniform formula for profit allocation applicable to all cantons. That inevitably causes double taxation due to tax base overlap. Namely, each eligible canton would apply different rules on the same amount of revenue for the purpose of computing its taxable share. The cantons’ fiscal legislation has never contained adequate guidance in connection with the allocation of profit. Development came from the Swiss Federal Tribunal’s jurisprudence. Over time, case law gave rise to the formation of certain principles which provide orientation to the cantons in determining their tax share.

The Court clarified that each canton may only tax a certain part of an entity’s profit. That should correspond to the proportion between the productive factors in the canton and all productive factors of the entity. There is no generally-applicable formula. Instead, the factors vary, depending on the type of activity carried on by the entity. For instance, industrial enterprises apportion income on the basis of assets and payroll and commercial businesses on the basis of turnover. Finally, in insurance, the factors are premiums earned and capitalised assets.

IV. Germany

1027 ibid 15.
1028 MB Carroll, Taxation of Foreign and National Enterprises vol. iv – Methods of Allocating Taxable Income (30 September 1933) LN Doc 425(b) M 217(b) 1933 IIA 67 (hereinafter Carroll).
1029 ibid 67-68.
1031 Carroll 69; Célestin 139; Ruding Report Chapter 9, Section II.
1032 Carroll 70.
In Germany, use of FA is made by the municipalities. That is the third tier of administration in a federal structure.\textsuperscript{1034} It concerns the allocation of entitlement to levy trade tax, for which the taxing jurisdiction is with the municipalities exclusively. Thus, all municipalities in which an operating unit\textsuperscript{1035} of a company is located shall be attributed some amount for the purpose of subjecting it to trade taxation. That is a single-factor FA based on payroll.\textsuperscript{1036}

Part C: FA in the EC Group Taxation Initiative

Allocation of profit by FA contributes decisively to fulfilment of a key objective of the EC group taxation initiatives. That is to render transfer pricing compliance obligations redundant.\textsuperscript{1037} Devising the specific elements of the formula is normally a task for economists. Further, a policy choice of such scale is expected to bear a strong impact on business decisions. As a result, prior to giving shape to a policy choice for FA, macro-economic implications need to be examined and measured. Since this thesis explores group taxation in the EC from a legal perspective, analysis will be limited to law-related aspects of an EC-wide formula.

I. A Uniform FA for the EC?

\textsuperscript{1033} Célestin 140.
\textsuperscript{1034} M Ardizzoni, \textit{German Tax and Business Law} (Sweet & Maxwell, London 2005) §6-003.
\textsuperscript{1035} ibid §6-012.
The implementation of FA by virtue of common rules is not a self-evident policy option. Historical data set out in Part B above witness a clear trend towards harmonisation of FA rules applying at sub-federal level. The ten Canadian provinces in principle apply a uniform regime, with the exception of Québec. In Switzerland, the jurisprudence of the Federal Court had formed common principles for apportionment as early as the 1930s whilst tax base harmonisation only came into force in the 21st century. Finally, the US, staying generally firm to practices that favour tax competition, accommodates disparate formulae. Still though, a certain degree of uniformity has been attained through the adoption of the ‘Massachusetts’ Formula in the context of UDITPA and the Multistate Tax Compact. Further, maintaining financial accounts based on US GAAP as well as the existence of a single currency add to common features. In light of the above, the question is whether an EC group taxation system should provide for one single FA or, instead, allow diversity. This draws upon the policy discussion on regulation or de-regulation in multi-jurisdictional structures.

One prerequisite for attaining the EC objective for the abolition of double taxation (TEC art 293) is to apply uniform apportionment rules within each group. However, this objective cannot, in all cases, sustain a requirement for uniformity of regulation across the entire EIM. As regards the formula, it suffices, for double taxation to be prevented, that entities of each single group are subject to common rules. In this way, no tax base overlap should occur. Under the proposed EC schemes, apportionment is carried out by the parent entity for the entire group. It follows that

1039 Bundesgesetz über die Harmonisierung der direkten Steuern der Kantone und Gemeinden (SHG) of 14 December 1990; art 129 of the Federal Constitution of 18 April 1999 (Federal Constitution of 2 May 1874 art 42quinquies, as amended by the Referendum of 12 June 1977). The cantons were given until 31th December 2000 to bring their tax regimes in conformity with the Tax Harmonisation Law (THL).
1040 Genetelli 13; Weiner (2002a) 526.
1041 Transfer Pricing Guidelines III-23; McLure & Weiner 260.
1042 See Chapter 4, Part A.
double taxation risks are tackled, provided that common regulation (i.e. the parent company’s rules) applies across each group. Beyond this, no further uniformity is required by the Treaty.

As pointed out in chapter 7,1043 overlap in the US is caused because apportionment is not centralised within each combined group. Namely, each State, hosting at least one unitary entity computes its tax share individually. As a result, the same group revenues become elements of more than one tax base calculation. A similar approach is taken by the cantons in Switzerland but within the context of a single entity being taxable in more than one jurisdiction. Therefore, the envisaged EC schemes involve a fundamental difference from existent allocation mechanisms in federal countries.

Allowing each Member State, host to a parent company, to apply its own rules across the group places a requirement for mutuality. This means that Member States accommodating subsidiaries should accept the allocation of taxable share performed by the parent entity’s state.

Discrimination or restriction risks do not appear to arise. More specifically, no comparison can be sustained from the perspective of the subsidiaries’ origin state. Foreign-held subsidiaries may bear a higher tax burden than those held locally, due to the fact that they are subject to the tax rules of the state of their parent.1044 This is a result of disparities in EC national tax systems. Thus, by crossing the border to raise capital, entities subject themselves to another Member State’s tax rules. Those rules may lead to higher taxation. No guarantee is given for lower taxes in those cases.1045 From a host state perspective, the parent entity applies the same rules to both domestic and foreign group members. So, no discrimination/restriction comes to fore, as a result of this treatment.

1043 See Chapter 7, Part B, Section 1.
1044 This is possible under the HST proposal.
Allowing diversity of FA, as set out above, enhances tax competition among the Member States, without giving rise to market distortions. It is obvious that the ultimate objective of creating one single set of rules for MNEs’ compliance in the EC could be compromised to some extent. This should not be feared in all cases though. Namely, MNEs will be faced with more than one set of rules in the EC only if they operate through more than one group in the EIM.\textsuperscript{1046}

However, a consideration of the above in conjunction with the proposed ownership-based definition of group\textsuperscript{1047} creates an increased risk of abuse. More specifically, MNEs could be attracted by the prospect of artificially putting together, under the same parent entity, groups engaged in unrelated activities. The parent entity, possibly a holding company, would be set up in the most attractive EC tax jurisdiction to grant the entire group the maximum of benefit. It follows that, to deal with the above abusive behaviour,\textsuperscript{1048} anti-avoidance measures should be taken in determining the group membership entitlement.

To conclude on the above discussion, FA does not necessarily have to take a uniform structure across the EC. Apparently, a uniform EC-wide applicable FA offers simplicity. It is, however, possible that Member States fail to agree on one single formula. In such a case, the Treaty objectives could still be fulfilled, provided that each group is regulated by a common set of rules. This can be achieved if the rules of the parent entity’s state apply across the group. Further, FA diversity would enhance competition. Yet, it would also place increased abuse risks, possibly shaped to manipulate the group definition. Hence, an attempt should be made to tackle those practices through curbing attempts of tax avoidance at the level of group membership entitlement.

\textsuperscript{1045} ACT GLO para 46.
\textsuperscript{1046} This would normally mean that an MNE operates totally unrelated businesses through separate corporate structures of which the EC parts do not fall under common ownership.
\textsuperscript{1047} See Chapter 6, Part B, Section II.
II. The Factors

As regards the choice and content of factors, the EIM, in principle, does not appear to raise specific requirements, peculiar to its constitutional structure. So, general discussion on FA should be a guiding principle for EC policy decisions – at least, as a starting point.

(i) Can the ‘Massachusetts’ Formula Stay Alive for Long?

A decision on which factors should be included into FA is normally reached on the basis of public finance considerations. Different approaches can be identified as regards the choice of factors. For instance, the ‘Massachusetts Formula’ constitutes a starting point in the US whereas, in Switzerland, the particularities of each industry are the focal issue.

The ‘Massachusetts’ model is widely referred to and still occupies a prominent position among the US States’ choice of formulae. Yet, as already explained, there currently is an apparent shift towards a single-factor formula based on sales. Competition among the US States is one reason for this development. Still, the shift can also be explained on other grounds. Thus, the equally-weighted three-factor formula was created to meet the needs of manufacturing business, which, at the time, dominated the market. Ever since the first half of the twentieth century, though, the world economy has undertaken radical changes and services became a crucial part of it. In the EC, they currently account for 60 to 70 percent of economic activity

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1048 See Chapter 6, Part B, Section II with special focus on (i) & (ii).
1049 According to data of 1 January 2007, twenty five (25) US States have adopted substantial portions of the UDITPA formula, which actually corresponds to the ‘Massachusetts’ formula: State Apportionment Formulae 2007.
1050 Carroll 69.
1051 See earlier in this chapter Part B, Section I (on the USA).
1052 For competition for inward investment, see McIntyre (2004) 920.
and a similar (and rising) proportion of overall employment. It is obvious that a formula tailored to fit into manufacture may no more prove suitable for the entire spectrum of commercial activity in the EC.

In light of the above, a formula for the EIM should apparently accommodate factors suitable to produce a fair result when apportioning revenues derived from services. For instance, sales and payroll appear to be much more closely related to services than property. That would lead to a two-factor FA with weight equally balanced between the Member State of the provider’s establishment and the locations where services are supplied.

The literature extensively covers risks of manipulation usually attached to payroll and sales. Overall, those involve taking advantage of certain mobile elements of the above factors, to the end of shifting income. Typical examples include using contractors, instead of employees based in a fixed location, as the former normally fall outside the scope of payroll. Sales, placing weight at destination, may easily be directed towards a certain jurisdiction for the purpose of producing an advantageous result. As the above abuse risks do not seem to create complexities specifically related to the EC, no further elaboration will be made here. This is a matter, inherent in FA, which should be researched in that context rather than as part of this thesis which has a different focus.

(ii) Industry-Specific Formulae

Considering the importance of services in the EIM, the prospect of devising industry-specific formulae should be discussed. A possibility could be to create two

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1053 Christensen 1150-1153 (esp. on the problem of intangibles).
1055 For instance, see: Christensen 1148-1152, Weiner (1999) 24 et seq.
types of FA: a ‘Massachusetts’ formula to apply to manufacturing business and a
two-factor scheme, based on payroll and sales, to apportion revenue from services.

Industry-specific formulae do not always fit smoothly into vertically integrated
MNE structures. Globalisation has led to business structures which bring activities
such as manufacture and various services related to produced brands under the same
economic ownership.\textsuperscript{1057} Industry-specific formulae would require that revenues
derived from manufacture and the sale of goods be apportioned separately from
those earned through providing services. Such a practice would overtly defeat the
purpose and objectives of a unitary definition of the group, as flows of values
between the different parts of the business would be ignored. Further, it should be
expected that income would be shifted towards services, aiming at taking advantage
of the more mobile factors of payroll, through use of contractors, and of sales.

Even under a test of legal ownership for group definition, the use of different FAs
should, in substance, create the same problems as under the unitary rule. This may
only be avoided if, in a specific case, ties among the group members are merely
artificial. This is, though, a situation to be avoided through anti-avoidance rules.

\textit{(iii) Defining the Factors}

Elements contained in the definition of FA factors often impact on business
investment decisions.\textsuperscript{1058} For instance, as said, if payroll is limited to employees, it is
highly probable that businesses will try to shift part of their commercial activity to
contractors. In that way, the value of payroll will be reduced considerably. Further,
as regards the incidence of tax, McLure\textsuperscript{1059} has shown that, through FA, US States
transformed State Corporate Income Tax into a direct tax on FA factors. It follows

\textsuperscript{1058} Weiner (1999) 21 et seq.
\textsuperscript{1059} McLure (1986a) 70.
that tax is likely to mainly be borne by immobile elements of the factors.¹⁰⁶¹ That is, those parts of the factors which cannot be shifted outside the State’s tax base. They often involve residents of the taxing state in their capacity as consumers, immobile workers and owners of land.

The precise definition of factors in the EC will largely depend on public finance decisions. This is certainly a matter with political ramifications.¹⁰⁶¹ Broadly, an increase in weight of in-state factors would favour maximisation of the domestic tax base.¹⁰⁶² Conversely, double-weighting sales at destination would create an incentive for inward investment through limiting the taxing entitlement of the production state. Member States may be faced with difficulty in striking a deal on this. Thus, the European Union, despite being in part a monetary union (EMU), has not yet accomplished economic integration. As a result, the Member States do not share similar priorities in their public finance policies. If compromise cannot be reached, it may be worth considering the prospect of allowing each parent company’s Member State to apply its own FA across the group.¹⁰⁶³

Financial Accounts versus Tax Accounts¹⁰⁶⁴

None of the EC group taxation initiatives provides for the harmonisation of financial accounting rules of the Member States. Uniformity plans do not go any further than the creation of a common tax base. Indeed, accounting practices vary among the Member States.¹⁰⁶⁵ Further, the obligation to apply IFRS/IAS is limited to companies of which securities are admitted to trading on a regulated market of a Member State.¹⁰⁶⁶

¹⁰⁶⁰ Bird and Brean 1399.
¹⁰⁶¹ Weiner (1999) 21 et seq.
¹⁰⁶² McLure & Weiner 266-269.
¹⁰⁶³ see earlier in this Chapter: Part C, Section I.
¹⁰⁶⁴ Transfer Pricing Guidelines III-23; McLure & Weiner 260.
In light of this, the question arising is which accounts the values of factors will be derived from. If the aim is to create a uniform formula, then the factors should be computed under common rules. In three1067 of the four EC initiatives, group entities have to prepare tax accounts under common rules. Using these accounts to compute the factors’ values appears the only feasible solution, given the divergence in financial accounting rules. It is, though, financial accounts which depict a company’s results more accurately. Adjustments made to them, for tax purposes, may partly distort the initial picture. Yet, there does not seem to be any better option to consider.

(iv) The VAT-based FA

The European Commission policy documents1068 propose an adjusted version of the harmonised VAT base1069 as a starting point in creating a single-factor FA. Given the difficulties connected with working out common rules for sales, property or payroll, this is an option worth considering.

The proposal has been for an origin-based value-added factor, which implies that a number of adjustments to the current structure will be required.1070 More specifically, exports will have to be brought into the tax base and imports to be excluded. This is necessary to protect the taxing entitlement of the Member State in which the economic activity originates. Otherwise, there would be an effect such as...

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1067 CCCTB, EUCIT and the Single Harmonised Tax Base.
1068 Staff Paper 504; COM(2003)726 21; apart from the policy documents of the European institutions, Lodin and Gammie’s HST also elaborates on the prospect of a formula based on value added: HST (Lodin and Gammie) 47-50.
1070 Weiner (2005) 47.
that of sales allocated to destination, which is applied by several US States to support inward investment.

As the aim is to catch value-added at origin, FA will take the form of an implicit tax on the factors of production.\textsuperscript{1071} Given the absence of tax rate harmonisation in VAT, the origin approach may raise income shifting concerns. Thus, the destination principle was adopted as a transitional regime to tackle manipulation in cross-border cases and preserve neutrality of the system.\textsuperscript{1072} In the absence of tax rate uniformity, detaching tax from the location of consumption would encourage artificial income-shifting schemes to flourish. In that sense, the objective of combating transfer pricing through consolidation and apportionment would be seriously undermined. Further, there are economics arguments\textsuperscript{1073} which favour allocation of some value to the marketing location.\textsuperscript{1074} Taking account of the interplay between supply and demand is also treated as leading to inter-jurisdictional equity.\textsuperscript{1075}

Further, the VAT regime on investment goods will have to be replaced by depreciation rules suitable to apply within a direct taxation framework. Under the Sixth Directive, the entire amount of input VAT incurred in connection with investment goods is set off against output VAT upon acquisition.\textsuperscript{1076} The amount of input VAT that has been deducted upon acquisition is then subject to a five-year adjustment.\textsuperscript{1077} Such a scheme is not suitable for a system of direct taxes.

\textsuperscript{1071} ibid 48.
\textsuperscript{1072} I Roxan, 'Locating the Fixed Establishment in VAT' [1998] British Tax Review 608, 618 et seq.
\textsuperscript{1074} The marketing location does not necessarily coincide with the production state. It is, however, a suitable direct tax proxy for consumption.
\textsuperscript{1075} Musgrave (1984) 231.
\textsuperscript{1076} This is so, provided that the sector of the company’s business served by those goods engages in an activity taxable for VAT purposes.
\textsuperscript{1077} No adjustment shall be applied insofar as the investment goods are used in Vatable transactions. In the event that the goods cease to serve VATable activity before the 5-year period is over, an adjustment is required to account for the remaining time. That is 1/5 of the overall input VAT for each year of the adjustment period. So, in the case that VATable activity ceases in the course of the third year, 3/5 of the input VAT already deducted upon purchase shall be adjusted.
Macro-economic approaches\textsuperscript{1078} to the matter have also been put forward. It is suggested that allocation may be done in accordance with each country’s share of the aggregate EU VAT base.

Evaluating the prospect of adopting a VAT-based FA is mainly a task for economics which lies beyond the scope of this thesis. The legal perspective primarily deals with how the scheme should be scheduled once economic research arrives at the conclusion that it is worth implementing.

Conclusion

The EC project relating to FA raises interesting challenges. Examples can be derived from the experiences of countries with long-lasting expertise in the field. However, choices should be adjusted to the realities of the EU. The absence of common rules for financial accounting makes the implementation of factors, already tried in the US and Canada, a complicated process. Further, lack of economic integration is bound to be an impediment to a Member States’ agreement on the FA factors. It is normal that states do not share similar public finance priorities. In light of this, a formula based on value-added is a prospect which cannot be excluded at this stage. It seems though to suffer a major drawback related to transfer prices if scheduled as an origin-based scheme. Economists’ research may provide more input on this in the near future. For the time being, a value-added formula which balances production and marketing states can certainly be an option for consideration.

To conclude, FA may be structured to fulfil the objectives of an EC-wide group taxation system. Even where not fully harmonised, no complexity is caused insofar

\textsuperscript{1078} PB Sørensen, \textit{Company Tax Reform in the European Union} (Economic Policy Research Unit, Institute of Economics University of Copenhagen, 2003) 9.
as the parent state's rules are applied across the group. Further, in determining FA factors, account should be taken of the large share that services occupy in EC Member States' economies. The 'Massachusetts' formula does not appear the best solution for accommodating commercial structures of the 21st century.
CONCLUSION

The main research question of this thesis has dealt with the prospect for creating a group taxation system meant to allow groups of companies active in more than one EC Member State to be taxable under one single set of rules. The objective has been to specify what shape the elements of such a system should take as well as to identify the areas of complexity or probable impasse.

It has been explained in the Introduction to this thesis that the creation of such a scheme for group taxation has no precedent internationally. This is where its novelty derives from. An EC-wide group taxation system is intended to extend across national jurisdictions within an internal market which has set itself objectives of close integration. A novel setting is thus created by the scheme’s multi-jurisdictional dimension and the effort to strike a balance between the objectives of market integration and Member States’ sovereignty.

Another striking feature, generally relevant to direct taxation, is the limited amount of EC legislation in the field of corporate taxes. Most development accomplished in the area is a result of the ECJ’s jurisprudence. This is, however, a fragmented approach, since the court cannot go beyond the facts of the case brought before it. Inevitably, therefore, the ECJ’s rulings have an impact of limited scope – even occasionally strong.\footnote{For instance, M&S; see earlier in this thesis Chapter 1, Part B, Section II, Title B.}

Devising a group taxation scheme is a totally distinct process from that leading to the ECJ’s jurisprudence. As explained in Chapter 4 of this thesis, the former involves rules which refer to broader objectives inherent in the EC Treaty.\footnote{Those objectives do not have direct effect, which means that they are not individually}
enforceable before the courts. It follows that group taxation is not about devising a scheme to fix an infringement of the EC Treaty, which is broadly what the ECJ focuses on. Still though, any created scheme for group taxation should not contain features that breach the non-discrimination/non-restriction tests of the ECJ. Considering this, two background chapters on the ECJ’s jurisprudence and positive integration respectively have been incorporated into this thesis. They set the current state of affairs in corporate taxation in the EIM. This is the setting in which group taxation initiatives should fit.

Before moving on to exploring each individual element of the group taxation scheme, the following question had to be answered: whether regulation, aiming at the elimination of disparities, is necessary in creating a setting of efficiency for the EIM. In effect, the conclusion has been that, despite the silence of the EC Treaty, some degree of uniformity appears a necessity in paving the way to market integration. Examples were drawn from the structure of sub-national corporate taxes in the US and in Switzerland. Those countries do not, in principle, share the view that regulation contributes vitally to accomplishing market integration. It was explained, though, that these states accommodate certain features ensuring a degree of approximation at sub-federal level. Further, it was shown that the mechanisms which led to such approximation in the two countries are absent from the EC. As a result, the discussion concluded that regulation should be treated as the primary means to establish a certain amount of unity within the EIM.

II. The Elements of the Scheme

1080 See Chapter 4, Part B, Section I.
1081 Ibid.
The conclusions reached in each individual chapter of the thesis on the elements of an EC-wide group taxation scheme will be discussed below. In addition to surveying each feature separately, the identified interactions will also be explored.\footnote{1082}

(i) Entitlement to Group Membership

Different tests for group membership, also derived from fields outside direct taxation, were explored. Among them, the unitary business incorporates a fundamentally distinct concept of group definition. It is built through the use of substantive criteria and its existence is buttressed on the unity of commercial activity. The other three tests (i.e. ownership, control and VAT grouping) are more technical in nature. Ownership is measured by reference to holding percentage. Further, control in principle features in company law and deals with voting rights. Finally, the rules applying to VAT grouping employ the same parameters (i.e. holding percentage) as ownership tests. So, in practice, this cannot be a self-standing solution.

The choice made in this thesis is for a technical test. The principal argument behind is the uncertainty inherent in defining a unitary business.\footnote{1083} This should be considered in conjunction with the assumption that group membership will be determined by one single authority – most possibly, that of the parent entity. It is thus clear that an uncertain test on group membership would increase the number of disputes among the participating states over the decision on group membership.

It is true that technical tests for group membership do not interact smoothly with the allocation of the group taxable base by FA. Indeed, FA, by definition, produces

\footnote{1082} Those interactions mainly concern the compatibility of a technical test for determining entitlement to group membership with FA. The relation between the methods for tax base integration and FA is also relevant.

\footnote{1083} See Chapter 6, Part B, Section II.
accurate results only in the context of a single business. Otherwise, differences in profitability and in the weight of the factors distort the outcome of the apportionment. Thus, this is also demonstrated by the fact that, at the level of group taxation, FA has so far been linked to a unitary definition. Considering this, the conclusion is that there should be a certain degree of coherence in the business fields in which a group engages. Otherwise, significant distortion would be inevitable and the scheme would be prone to manipulation. It should be noted, though, that, in Canada and Switzerland, FA is applied to apportion revenues of a single entity to the eligible provinces and cantons respectively. Typically, it is not necessary that only one business activity is carried on through a certain entity. So, there is a precedent of apportioning more than one business through the same FA.

Technical tests may also give rise to concerns of tax abuse. This is, in principle, related to the fact that the lack of substantive criteria allows manipulation consisting of artificially incorporating business activities into a group. It has been proposed that a system of monitoring be put in place. In that context, transfers of business into group entities, shortly before or after their registration as group members, should be tested for their commercial purpose. The taxpayer may also bear the onus of providing evidence that there is no tax avoidance purpose in bringing a new activity into the group.

In deciding for a technical test, this thesis also advanced a position in favour of an ownership criterion as opposed to control. It was thus argued that control highlights a degree of unity which shareholding tests alone are not in a position to ensure. However, this is no guarantee of unity of the business activity. Rather, it is instead a management-related unity. So, control tests do not add substantive elements to the tax system. In that sense, control does not make a better solution than ownership. Further, ownership was found to be a more suitable policy choice than control. More specifically, the items attached to control highlight issues which

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1084 See Chapter 6, Part B, Section I.
1085 See Chapter 6, Part B, Section II.
are crucial to company law. In contrast, when it comes to taxation, the decisive element is profit, since it roughly provides the basis for computation of the fiscal liability. In this context, ownership, in the form of shareholding, is naturally the decisive factor in determining entitlement to distributed profit.

(ii) The Group Tax Base

Examples were drawn from national group taxation systems to show that the terms ‘consolidation’ and ‘pooling’ are often used interchangeably. There is no clear distinction between the two but this is not a matter of practical significance in an EC group taxation system. It has also been demonstrated that common rules should apply to computing the tax base within each group for the purpose of preventing overlap. That is, uniformity does not necessarily need to extend across the EC. It rather suffices to have common rules confined to each group. In this way, the taxpayer is still subject to one set of rules. Conversely, rate divergence does not cause distortion. Instead, it contributes to retaining a certain amount of tax competition within the market.

This thesis also explored how a system of consolidation/pooling interacts with separate accounting and FA in computing taxable profit. It was concluded that, in a framework comprising more than one taxing jurisdiction, consolidation/pooling is incompatible with separate accounting. On the other hand, there is an inextricable link between FA and consolidation when it comes to a cross-border group. Thus, the allocation of the taxable base by FA in principle presupposes the existence of a single tax base. Apart from that, the degree of integration of the single group base does not seem to have an impact on the FA.

1086 Ibid.
As regards the elements to be incorporated into the tax base, the view taken in this thesis is for a broad definition. The aim is to bring as many elements as possible into the FA. A distinction between business and non-business income, similar to that of UDITPA, would allow transfer pricing to survive into the system. This is because non-consolidated items would need to comply with the formalities of pricing at arm’s length. Considering that combating transfer pricing compliance costs is one of the key objectives of the EC-wide group taxation initiatives, keeping these low should be a guiding principle.

(iii) The Territorial Scope

The term which dominates discussion on the territorial scope of an EC group taxation system is ‘water’s edge’. This thesis does not challenge the policy choice to apply ‘water’s edge’ to EC group taxation. Rather, it builds on that assumption. In Chapter 8, the analysis demonstrated how the concept evolved, in conjunction with unitary taxation, throughout the twentieth century. There is also discussion of the rules on ‘water’s edge’ as set out in the US Multistate Tax Model.

In deciding on the territorial width of an EC-wide group taxation system, trading proceeds and passive income were considered without distinction in this thesis. That is in line with the view that the group tax base subject to apportionment should be the broadest possible. Account has also been taken of the intra-EC aspect of a possible distinction between business and non-business income. This has an impact on delineating the intra-EC territorial contours of the group. Namely, the Member States may decide to exclude inflows of passive income derived from non-affiliated entities resident in the EC from the group tax base. Those will then have to be

1087 This is also the position of the European Commission: see WG Doc 4 on Int’l Aspects para 7.
1088 Staff Paper 255 et seq.
1089 See Chapter 8, Introduction.
1090 See Chapter 8, Part B, Section III, Title 2.
1091 WG Doc 4 on Int’l Aspects para 7.
allocated to the recipient group on the basis of arm’s length pricing which brings forth obligations for compliance with transfer pricing norms.

The focal matter in defining an EC-wide group’s territory touches upon the clash caused as a result of applying FA internally and international tax rules in dealings with entities outside ‘water’s edge’. From the perspective of the EC, two sets of facts have been identified:

(1) Where relief should be given within ‘water’s edge’ for tax paid in a third country by a PE or for withholding tax on inflows of dividends, interest or royalties;

(2) Where income of a PE held by a third-country entity is taxed within ‘water’s edge’ as part of the group tax base.

In connection with (1), the analysis in this thesis was built on the thoughts put forward by the European Commission as part of the CCCTB project. There are two alternative ways to regulate the obligation to provide relief:

(a) Income generated outside ‘water’s edge’ is not admitted as part of the group tax base. This would imply that transfer pricing compliance obligations enter into the picture. As income will be allocated to the eligible Member States by attribution, the taxable value of individual transactions will have to be fixed at arm’s length. As a result, high costs for compliance with transfer pricing reporting obligations will persist, which will cancel part of the advantages expected to be derived from operating FA.

(b) Income sourced outside ‘water’s edge’ is incorporated into the consolidated/pooled tax base. A problem surfaces where the Member State of the Head Office’s residence is bound by the DTC concluded with the state of the PE’s location to provide relief by credit for source taxation borne by the PE. Provided the PE income is consolidated/pooled and apportioned across the group, the credit should also be apportioned. It has been explained how DTC obligations clash with

the possible methods for allocating that credit across the group. In this regard, it was found that mechanisms for relief in the US and UK tax systems could provide an example of apportioning credit without a need to amend DTCs. The existing US and UK schemes do not involve identical sets of facts as those in issue but the underlying question is common to both. A critical matter is that the EC-wide group should typically qualify as a single entity – if a parallel is to be drawn to the above US and UK schemes. However, given that the Member States are meant to retain their full sovereignty in taxation, each group member will be due to settle its tax liabilities individually. That points to a structure clearly distinguishable from the concept of single entity.

The situation under (2) is most likely to create problems at the DTC level if the PE’s tax liability computed by FA is higher than the outcome of an attribution at arm’s length. Thus, the third country (where the Head Office is resident) is then likely to object that the jurisdiction of source goes beyond its taxing entitlement. In that context, the need to re-negotiate DTCs comes to the fore once again. The chances of a solution, through accepting the result of FA, in principle depend on the third country. No apportionment is required here for the purpose of computing the amount for which relief should be granted. This is because the PE’s taxable base and fiscal liability in the Member State of source are identifiable.

(iv) Formulary Apportionment

It was shown that the formula does not have to be uniform across the EC. Indeed, to the end of preventing distortion, it suffices that common rules apply to each single group. Further, this thesis casts doubt on whether the ‘Massachusetts’ formula is appropriate to apportion income from services. Finally, the possibility of a VAT-

1093 WG Doc 2 on Int’l Aspects paras 7 & 8.
1094 See Chapter 8, Part B, Section III, Title 2.(i).
1095 Chapter 8, Part B, Section III, Title 2.(ii).
based formula is also explored but it is mentioned that any in-depth study is primarily a task for economists.

(v) Administrative Matters

A number of areas relevant to administering an EC-wide group taxation system were explored. In most fields, it has been very complicated to work out solutions and this is more precisely true for dispute resolution and tax audits. Still though, some proposals have been made.

The analysis was divided into four sections: compliance, enforcement, dispute resolution and re-assessment of tax liability.

In the field of compliance, possible options were considered for group registration and return filing as well as for determining the taxable periods. Where relevant to the issues discussed, examples were drawn from national group taxation systems in Europe or the practice of US unitary states. An effort has been made to strike a balance between integration objectives and Member States’ sovereignty.

It was thus put forward that registration formalities should be carried out in the parent entity’s state, whilst a mechanism should be set up to allow the Member States to object to that.

Regarding return filing, the prospect of a single tax return seems to be out of the question, since each Member State is due to retain its own taxing jurisdiction. On that assumption, the only significant contribution of a scheme akin to a ‘one-stop-shop’ would be to allow the taxpayer to deal with only one tax administration.\textsuperscript{1096}

\textsuperscript{1096} E-Commerce VAT Directive.
In relation to fixing tax periods, this author’s view is that no definitive conclusions can be reached. The matter appears to be more of a policy choice. Further, international practice witnesses a clearly fragmented approach. In this thesis, the position taken is for accounting years which coincide, as otherwise coordination problems are bound to emerge.

A sophisticated system for the exchange of information is a necessity. In that context, mechanisms for the automatic transfer of data among the Member States will have to be created in specific matters. In addition, it is inevitable that extensive disclosure takes place in the context of audits. That could face the Member States’ strong opposition.

Brief reference was also made to the prospect of laying down a common framework for rulings. It was found that this will be necessary where the questions referred affect other states’ tax base entitlement.\textsuperscript{1097}

In the field of tax audits, it was explained that allowing the Member States to audit group entities separately would lead to chaotic situations. As a result, this thesis treats the prospect for furnishing the parent entity with the responsibility to carry out audits across the group as the only option.\textsuperscript{1098} It has been discussed that issues of sovereignty could trigger possible resistance to such a scheme by the Member States. In addition, it has been stressed that coordination and assistance among the Member States in the course of audits will be a condition for a successful operation. More specifically, given that financial reporting norms will remain disparate, local accountants’ assistance is expected to be valuable in reading the results of the group subsidiaries.

This thesis takes a two-fold approach to dispute settlement. That is, procedures for resolution should be in place to deal with disputes between Member States, on the

\textsuperscript{1097} See Chapter 5, Part B, Section II.
\textsuperscript{1098} See Chapter 5, Part B, Section III.
one hand, and taxpayers and revenue authorities, on the other. This is another reflection of the balance sought to be achieved between intergovernmental reality and market integration objectives.

In disputes between Member States, the proposal has been for a fast-track procedure of resolution. It is suggested that an initial period of six months for direct negotiation should be coupled with an arbitration panel, due to produce a binding decision in the next half-a-year. It is also set forth that the ECJ could provide the appropriate institutional structure to accommodate the above. Namely, TEC art 239, supplemented by a new set of Rules of Procedure, could be a suitable legal framework.

On the front of disputes between taxpayers and revenue authorities, the position taken is that the parent entity should be entitled to represent the group before the national (tax) courts and the ECJ. These cases will in principle fall within the competence of national courts and may be considered by the ECJ through a reference for preliminary ruling.

III. Evaluation of the Prospects for Implementation and Future Potential

On a consideration of purely technical matters, a group taxation system meant to subject MNEs to a single set of rules across the EC is a feasible project. This is true, irrespective of the complexities likely to emerge at the implementation stage. The discussion of the structural elements of such a scheme in the core chapters of this thesis has revealed areas which require specific regulation. This is primarily due to

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1099 See Chapter 5, Part C, Section II.
1100 See Chapter 5, Part C, Section III.
the new concepts inherent in group taxation, such as the rules for group definition, the computation of the group tax base and the structure of FA.

In this author's view, most of the technical difficulties related to implementing an EC-wide group taxation system are in principle possible to work out. The most complex part of the scheme touches upon the group's international dimension and, more precisely, involves the interaction between FA and pricing at arm's length.\textsuperscript{1101} This thesis sets forth examples from the UK and the US DTC practice in dealing with cases of apportionment.\textsuperscript{1102} Still though, where an EC-based PE is held by a third-country Head Office, the chances of arriving at a solution entirely depend on the third country. In other fields, ancillary measures may be needed to supplement the principal rule. For instance, the entitlement to group membership, if defined by reference to ownership, raises tax abuse concerns.\textsuperscript{1103} So, anti-avoidance legislation should be enacted to properly deal with this.

However, apart from the difficulties attached to the substance, political choice is also a crucial factor which often causes deadlock in a decision-making process. In an EC group taxation context, this implies that the Member States will have to be convinced that such an initiative is in favour of their interests. In light of this, it is vital that the proposed regulatory framework is given a form that the states would be likely to accept. For instance, in the CCCTB initiative, quarterly consultations take place between the Commission and a Working Group composed of national representatives. This should allow the Member States to make their views clear ahead of the Proposal for a Directive expected in 2008.

Another path for attracting the Member States' positive vote could be to make the group taxation proposal part of a wider compromise. This is a strategy successfully followed in the 'Tax Package', an initiative which the Council agreed to embark on in 1997. Two Directives (i.e. I &R and Savings Directives), together with a Code of

\textsuperscript{1101} See Chapter 8, Part B, Section III, Title 2.11 & (ii).
\textsuperscript{1102} Ibid

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Conduct for business taxation, became part of a single deal. The three acts could thus be adopted by the Member States either as a whole or not at all. That allowed a balance to be struck among conflicting national interests.\textsuperscript{104}

The legislators could also make an effort to render the new scheme more familiar to the Member States. That would definitely increase the chances for a positive reception. An example set forth in this thesis is to use the ECJ’s institutional framework, under a new set of Rules of Procedure, in resolving disputes between the Member States.\textsuperscript{105} In addition, the choice for an ownership test of group definition also draws on the Member States’ familiarity with the holding percentage in their national group taxation systems.\textsuperscript{106}

Europe does not currently seem determined to engage in pioneering action. Considering this, a failure to convince all Member States to adopt the group taxation scheme should be faced as a probable occurrence. This is all the more so, since unanimity in taxes is expected to be retained under any near-future replacement of the current treaties. Under these circumstances, it could be worth considering the prospect for laying down a framework of enhanced cooperation, so that the project can be advanced by the Member States wishing to move ahead.\textsuperscript{107} The drawbacks attached to the implementation of enhanced cooperation would be significant. More specifically, market fragmentation would persist. Further, transfer pricing and DTC matters inherent in the function of ‘water’s edge’ groups would now survive within the system on a larger scale. This is because pricing at arm’s length would not only be relevant to flows to and from third countries but also non-cooperating Member States.

\textsuperscript{103} See Chapter 6, Part B, Section II(ii).
\textsuperscript{104} <http://ec.europa.eu/taxation_customs/taxation/company_tax/gen_overview/index_en.htm>
\textsuperscript{105} See Chapter 5, Part C, Sections II & III.
\textsuperscript{106} See Chapter 6, Part B, Section II.
Overall, the creation of an EC-wide group taxation system does not appear a prospect for the very short-term. A Proposal for a Directive may come out in 2008. It could take, however, years until it reaches adoption by the Council. The history of decision-making at the EC level indicates that this may turn out to be a long process. In the meantime, it could perhaps be worth moving gradually towards a ‘comprehensive’ group taxation scheme through targeted approaches. Such a process would familiarise the national administrations with the new concepts. It would at least constitute a step forward.

This thesis has only meant to analyse the broad structural elements of an EC-wide group taxation system. It stayed at the level of framework and attempted to cover all the major policy decisions attached to a potential scheme. Given the current state of EC integration in direct taxes, more detailed research placed in a narrower scope could easily miss the target. So, this work is more of a start than an end.

Group taxation at EC level is a field which started to receive researchers’ attention in the last six years. That has obviously been in the aftermath of the Staff Paper. It is certain that EC group taxation will attract more interest in the coming years as ideas reach some maturity. Further, the European Commission’s initiative on the CCCTB is in progress and should take the form of a Proposal for Directive in the course of 2008. Significant headway should therefore be expected in the near future. This will primarily be at the policy-making level of the EU institutions. As said, the reception of those projects by the Member States remains doubtful.

This author’s aim will have been fulfilled if this work is still useful background reading in ten years’ time.

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1109 Staff Paper 325 et seq.
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