Maarten Floris de Wilde

Sharing the Pie

Taxing Multinationals in a Global Market

Sharing the Pie: Taxing Multinationals in a Global Market

Why this book?
Winner Johannes Cornelis Ruigrok Prize 2016 (Royal Dutch Society of the Sciences), Dissertation Prize 2016 (Dutch Association for Tax Sciences) and Erasmus Graduate School of Law Dissertation prize 2015.

What is the problem in corporate taxation? It is broader than any one country or company. Today's tax regime passed its sell-by date long ago. In the 1920s – when international business primarily revolved around bulk trade and bricks-and-mortar industries – levying a percentage of a company's profit in the way we still do today made sense. Businesses tended to be close to their customers and had a strong local physical presence. Today's markets, however, operate in a different reality. Companies now structure business on a regional – or even global – basis, while the Internet means physical presences are no longer necessary to service national markets. Globalization and internationalization have broadened the gap between tax and market reality. Taxation now influences business processes. Countries distort business decisions by not treating cross-border activities on a par with domestic equivalents. The lack of an internationally coordinated approach gives rise to double (non-)taxation issues.

Governments seem to be on the case, but what they're proposing doesn't suffice. Adhering to old status quos, the G20/OECD's BEPS initiative and recent EU measures like the ATAD focus on the symptoms of an ill-designed model rather than dealing with underlying root causes. Imagine designing a fair system from scratch – a "corporate tax 2.0". *Sharing the Pie* assesses issues in contemporary corporate taxation to arrive at an optimal alternative: *Tax Payable by Firm A in Country X = Tax Rate * Firm A's Worldwide Rents * (Domestic Sales / Worldwide Sales).*

The book is based on Dr de Wilde's PhD thesis, which was defended at Erasmus University Rotterdam on 15 January 2015 (cum laude). It has been updated to take into consideration recent developments in international company taxation (BEPS).

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Preface

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

The taxation of multinationals attracts a great deal of attention. The way companies arrange their tax affairs and the way countries compete via their tax systems are questioned by the general public. People perceive that multinationals do not contribute their fair shares – and are even facilitated by governments in not doing so – while annual tax bill increases are addressed to their workers and customers.

What went wrong? Perhaps the most serious problem is that country profit tax systems have become outdated and now end up encouraging tax-induced company behaviour. Today's tax systems date back to the 1920s and have been patched up time and time again, so that they are now no longer fit for purpose. These systems inherited from the past are based on locally organized businesses that are in close proximity to their customers and have a strong local physical presence. That well suited economic realities in the early days of international trade and commerce. Today's markets, however, operate in a different reality. Companies now structure business on a European or even global basis, while the Internet means that physical presences are no longer necessary to service national markets.

Tax systems have become unequipped to deal with contemporary business realities, while globalization and internationalization appear to be reinforcing the gap between these systems and the market realities in which they operate. Country tax systems now appear to be influencing business processes. Countries distort business decisions by not treating cross-border business activities on a par with domestic equivalents. The lack of an internationally coordinated approach gives rise to discrepancies that can result in profits being liable to double taxation or no taxation. Business decisions may, at times, be tax driven and hence less than optimal. That harms our economies and affects societal trust in the integrity of the tax system.

Current international actions won't cut the mustard. All leave existing tax frameworks essentially intact, treating the symptoms of an ill-designed model rather than dealing with underlying root causes. This goes for both the OECD/G20's base erosion and profit shifting (BEPS) initiative and this July's EU Anti-Tax Avoidance Directive (ATAD). The same is true for the Commission's attempts to target some Member States for having aided certain multinationals via their tax systems in contradiction with State aid

rules. Perhaps one should question whether analytical problems in taxation can ever be resolved within the same framework that created those problems in the first place. Perhaps we should fundamentally reconsider how we tax our multinationals.

Imagine designing a fair system from scratch: a “corporate tax 2.0”. That is exactly what this book does. It gradually transforms current international tax paradigms and modifies them step by step into an alternative framework for taxing multinationals. Briefly put, the proposed alternative would have three properties: the firm as a single taxpayer; a deduction for equity; and a sales-based apportionment. Today, countries typically subject corporate bodies to taxation as separate entities, regardless of whether these bodies are part of a functionally integrated firm. This creates all kinds of arbitrage, for the tax system has changed the manner in which firms legally arrange their business affairs in order to influence the tax cost. Treating the multinational as a single taxable entity would get rid of this with the stroke of a pen, as all intra-firm legal realities would be eliminated for tax purposes. Providing a tax deduction for equity, equivalent to that for interest, would create a system taxing above-normal profits only. The way investment was financed would become immaterial for calculating tax bills, promoting healthy business financing. Today, typically no such deduction is available, and this incentivizes firms to debt-finance investment. Tax base would be assigned to countries in proportion to where the firm involved sells its products and services. Today’s model instead assigns tax base to investment jurisdictions, creating a bias towards investment where effective tax rates are comparatively lowest, driving “races to the bottom” and putting pressure on national fiscal systems. A sales-based apportionment would bring that to an end, as investment locations would become immaterial for tax purposes. Corporate tax 2.0 would leave countries to apply their own rates and to retain autonomy in tax policy matters. It would provide countries an inelastic and hard-to-dodge tax base, since firms don’t control customer locations.

Sci-fi? It would just take one brave country or region to start the ball rolling. A sales-based unitary system taxing above-normal profits would stimulate investment in that country or region and, in turn, would encourage economic growth. A forecast of a strengthened competitive position provides a serious incentive to switch. If the first mover were to be eco-geopolitically relevant, others would have little option but to follow. It would be in their self interest. Any interactions between different tax systems would become increasingly neutral as more countries adopted the new approach. Such a self-interest-driven domino effect would transform the current distortive model into a growth-enhancing, fair, efficient and difficult-to-escape company tax.

This book forwards an assessment of the international tax regime of its own. It develops and forwards an out-of-the-box alternative to the confused way we currently tax multinationals. It is not an assessment of the OECD/G20 BEPS project or recent EU developments in the field of direct taxation. It rather and essentially is an autonomous assessment of those issues that have recently come to be known as BEPS. The manuscript was initially prepared as a PhD thesis, which was defended by the author at Erasmus University Rotterdam on 15 January 2015 (cum laude). (The thesis was awarded the Johannes Cornelis Ruigrok Prize 2016 by the Royal Dutch Society of the Sciences (*Koninklijke Hollandsche Maatschappij der Wetenschappen*) on 17 June 2016 and the Dissertation Prize 2016 by the Dutch Association for Tax Sciences (*Vereniging voor Belastingwetenschap*) on 22 September 2016.) The manuscript was prepared in pre-BEPS times, in the period from 2010-2014, and assessed by the doctoral committee during 2014. The writing process was formally finalized on 1 January 2015. Developments in international corporate taxation subsequent to that date have not been included in the analysis. Hence, the BEPS outcomes of 5 October 2015 are not included in this book (although the 2014 deliverables and BEPS report and Action Plan are); neither is the ATAD (although the original CCCTB proposal is). (For assessments of these developments, the reader is referred to the available literature, including the post-January 2015 papers on these subjects prepared by the author.) Although BEPS and ATAD are not explicitly assessed, their concepts and approaches nevertheless are. Digitization, mismatches, interest deductibility, controlled foreign company regimes, harmful tax competition, patent boxes, the definition of permanent establishment, transfer pricing (IP, risks etc.) and transparency (e.g. country-by-country reporting) are all extensively assessed in this book. So are EU concepts and approaches, including the fundamental freedoms, State aid and harmonization through the adoption of EU Directives. It is all there. That being said, the book nevertheless follows an independent course and proceeds in a completely different direction than current developments – perhaps save for some notions involving unitary taxation underlying the Commission's CCCTB relaunch of 15 June 2015.

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

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University (but which, unfortunately, I could not finish there, as the university had to close down the tax department for budgetary reasons in 2011). Thanks are due also to professor Sigrid Hemels, our current chair, for keeping the doors of the institute open, giving me the chance to continue and extend my research activities at Erasmus University for the years to come. Many thanks must also go to Loyens & Loeff N.V., the law firm I have been working with since 2006, for its support as a “backstop” when university budget cuts endangered the financing of my research. I feel particularly indebted to Paul Simonis and Rob Cornelisse for their efforts in this respect. Thank you, Paul; and thank you, Rob. I am also indebted to the Foundation for European Fiscal Studies for its support, and particularly to the foundation’s chair, professor Arnaud de Graaf.

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

Maarten Floris de Wilde
Zeist, 1 September 2016

Sample Chapter

Chapter 2

Some Thoughts on Fairness in Corporate Taxation

2.1. Introduction[77]

This chapter, the first constituent part of the analysis in this book, addresses the first subquestion, that is, how the concept of "fairness" in international corporate taxation should be understood. What should be the benchmark to assess the fairness or unfairness of the international tax regime? What constitute the principles for a sound tax system?

This chapter describes the concept of fairness as understood and interpreted by the author. Inspired by a combination of international tax theory and the objectives that underlie the legal framework of the European Union, the parameters of the author's notions on fairness in taxation will be addressed. These parameters will be based on how the author interprets the maxims of equity and economic efficiency as developed in international tax theory.[78]

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

The normative requirement of tax parity in equal economic circumstances, in the author's view, should be kept separate from the application of the relevant tax laws in a particular case. The reason for this is that the tax effects in the case at hand are tested against the benchmark of the notion of tax parity in equal circumstances, from which taxation is excluded as the subject of analysis. The tax effects in a particular scenario should be separated analytically from the fairness concept as these tax effects constitute

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77. This chapter draws from and further builds on Maarten F. de Wilde, "Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy", 38 *Intertax* 281 (2010).
78. *See*, for a comparison, Klaus Vogel, "Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Parts I, II & III)", 8/9 *Intertax* 216 (1988), at 216-228, 10 *Intertax* 310 (1988), at 310-320 and 11 *Intertax* 393 (1988), at 393-402; Nancy Kaufman, "Fairness and the Taxation of International Income", 29 *Law and Policy in International Business* 145 (1998), at 145-203; and Kevin Holmes, *The Concept of Income – A Multi-Disciplinary Analysis* (2001), at Chapter 1.

the "test object" against which the equality principle is tested. This allows a normative assessment of the tax effects without the tax effects influencing the outcome of the test; similarly, the results of a numerical calculation do not affect the underlying mathematical rules that determine the outcome.

It can be deduced from the equality postulate that everyone in an economic relationship with a tax state has the obligation to contribute to the financing of public goods from which one benefits in accordance with one's means – "equity".[79] Production factors should be distributed on the basis of market mechanisms without public interference – or at least with as little public interference as possible (economic efficiency). Taxation should follow economic reality rather than steering it, and it should not, either positively or negatively, affect business decisions – i.e. there should be tax neutrality, including neutrality of the legal form.

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

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

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

2.2.1.1. A corporate tax should also be fair

Fairness requirement in corporate taxation cannot be simply denied

International tax theory basically adheres widely to the notion that the allocation of the tax burden among taxpayers and the tax revenue between

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

nation states should be equitable and economically efficient.[80] These normative cornerstones of a fair tax system were already rudimentarily acknowledged in the 18th century by Adam Smith as the "maxims of equity".[81]

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

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

Corporate tax is a pre-individual tax: If individuals should be treated fairly for tax purposes, by inference, so should corporations

Some would dispute this position. Indeed, the legal entities that are subject to corporate tax are merely persons by virtue of the company laws under which they have been created. Corporate legal entities are persons by law, having legal personality, which allows them to operate a business legally and to derive a profit from it. Corporate entities can therefore, legally, also

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

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

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

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

be taxed. And indeed, as a corporate entity is just a legal construct in the end, the underlying individuals are the persons who ultimately effectively bear the tax imposed on the corporate entity. This does not mean, however, that it does not matter whether corporate entities are treated fairly or unfairly for tax purposes.

The first answer to the cynic might be that corporate tax conceptually operates as an "advance levy" on the income and consumption taxes imposed on the individuals behind the entity – the "aggregate theory".[84] And as the tax treatment of individuals should be fair, corporations should also receive fair tax treatment, as the corporate tax charged to a corporate body can be seen as a (temporary) replacement of the individual income tax chargeable to the individuals behind the corporate body.[85] So, if the individual ultimately pays corporate tax, it seems reasonable to argue that corporate tax should be levied equitably and neutrally, since the individuals behind the entity who effectively pay the tax should receive fair tax treatment.

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

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84. *See* Michael J. Graetz, "The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies", 54 *Tax Law Review* 261 (2001), at 301-306.
85. *See*, on the question of why to tax corporations in the first place, Richard M. Bird, "Why Tax Corporations?", 56 *Bulletin for International Taxation* 194 (2002), at 194-203; and Ruud de Mooij, "Will Corporate Income Taxation Survive?", 3 *De Economist* 153 (2005), at 292.
86. *See* Willem Vermeend et al., *Taxes and the Economy: A Survey on the Impact of Taxes on Growth, Employment, Investment, Consumption and the Environment* (2008), at 41 and 156.
87. *See*, for a comparison, Michael J. McIntyre, "Thoughts on the Future of the State Corporate Income Tax", 25 *State Tax Notes* 931 (23 September 2002), at 936-938; and Peter Harris, "The CCCTB GAAR: A Toothless Tiger or Russian Roulette?", in Dennis Weber (ed.), *CCCTB: Selected Issues* (2012), at 278.

Multinational firms exist as economic entities

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

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

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

It may be acknowledged that the firm's equity investors, the owners, do not operate the business through their corporate interests themselves. The

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

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

owners of the firm merely hold their interest as a portfolio investment as they are primarily interested in the economic return on their shareholdings rather than in the underlying business operations of the firm.

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

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

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

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

Multinational firms derive economic rents

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

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

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

The final response to the cynic could be the following. The fairness question cannot be denied in corporate taxation because it avoids something known as "fairness spillovers" to other taxes in the tax mix.

Let us assume that, for whatever reasons and on whatever grounds, a tax authority was going to introduce a corporation tax and no notions of fairness were going to be taken into account. In doing so, the tax authority would adopt a non-equitable and non-neutral tax. Such a tax would operate arbitrarily, spilling over to the other taxes in the tax mix such as the wage tax, the capital income tax, or the consumption tax. Would that be a problem? The answer to that question may very well be "Yes".

If the corporation tax were to operate arbitrarily – it would for instance be unable to sufficiently tax the multinational's economic rents, thereby

creating tax arbitrage – the tax authority that seeks to raise revenue to finance expenditure would need to resort to alternative means. It would, for instance, resort to raising wage taxes and consumption taxes, or the levies on real estate. The absence of fairness in the corporate tax – meaning the presence of inequity and non-neutrality in it – would accordingly have some spillover effects into the other taxes in the tax mix. That would render the alternative taxes unfair as well, namely by making them inequitable and distortive.

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

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

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

Before elaborating on the constituent parts of section 2.2.2., it is worth noting that the notions of fairness, meaning equity and economic efficiency, also lie at the heart of the legal framework on which the European Union has been built.[91] The cornerstone objectives underlying the European Union –

91. *See*, for a comparison, Peter Harris et al., *International Commercial Tax* (2010), at 96.

which align with the common values of the Member States – correspond to the notions on which international tax theory has been based, at least indirectly. This deserves further discussion here.

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

To enhance equity and economic efficiency within the internal market – put in the perspective of direct taxation by the Member States – the direct tax systems of the EU Member States need to be harmonized.[94] At the same time, where EU law applies, the abolition of all unilaterally imposed obstacles to cross-border movements of goods, services, persons and capital is required: the European Union's "free movements" or "fundamental freedoms". The area without internal frontiers has been established as a means to reach these objectives. The European Union is an autonomous suprana-

92. *See* the preamble to the Treaty on European Union (TEU) and Article 3 TEU. For some further analysis, *see* Frans Vanistendael, "No European Taxation without European Representation", 9 *EC Tax Review* 142 (2000), at 142.

93. Article 2 Treaty on European Union in conjunction with Articles 26 and 119 Treaty on the Functioning of the European Union. *See* Court of Justice, case 15/81 (*Gaston Schul*).

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

tional legal order and EU law has direct effect in the relevant domestic legal orders of the EU Member States.[95]

However, today, harmonization of the direct taxation systems of the EU Member States has been attained only to a very limited extent. With the exception of the prohibition of State aid and a few Directives, at the moment, the competences in the area of direct taxation lie completely at the level of the EU Member States. A basic property of EU law in the field of direct taxation is that when the European Union was founded no competences to levy direct taxes were transferred from the Member States to the Union. Today, the EU Member States have the power to veto any European Commission proposal that involves a transfer of sovereignty in the field of direct taxation to the European Union.[96] Consequently, within the internal market without internal frontiers, fiscal sovereignty is fragmented into as many autonomous tax jurisdictions as the European Union has Member States – currently 28. In direct taxation, a true internal market without internal frontiers does not (yet) exist. It is a "work in progress". Accordingly, the sovereignty of the Member States in the field of direct taxation does not substantially differ from that of the sovereignty of non-EU Member States.

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

Please note that this sample chapter is limited to 10 pages.
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95. *See* Court of Justice, cases 26/62 (*Van Gend & Loos*) and 6/64 (*Costa/ENEL*).
96. Article 115 Treaty on the Functioning of the European Union.
97. *See* Court of Justice, cases C-336/96 (*Gilly*); C-446/03 (*Marks & Spencer II*); C-265/04 (*Bouanich*); C-307/97 (*Saint Gobain*); and C-170/05 (*Denkavit Internationaal*). The same applies under the case law of the European Free Trade Association (EFTA) Court regarding the Member States of the European Economic Area. *See* EFTA Court, case E-7/07 (*Seabrokers*).

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