European Union

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Blueprint for a New Common Corporate Tax Base

In response to the shortcomings of the corporate tax systems of the Western world, the OECD has initiated its Base Erosion and Profit Shifting initiative. Similarly, actions have been endorsed by the European Commission in its fight against aggressive tax planning. The author, in this article, takes a different approach to the issue by examining alternative concepts of a harmonized tax base with respect to routine profits and centralized taxation of residual profits within the European Union.

1. Introduction

> Thirdly, I would like to point out that the laws of nature, the laws that govern all species, dictate change. We humans grow older year by year, and as we age, we hope we gain wisdom. The structure of society also changes as the years go by. Those who believe that the current structure of society cannot and must not change are making the same mistake as those in antiquity who believed that society could not survive without slavery. The only thing we know for sure about the future is that there will be a time when the present certainties no longer exist and that future societies will be structured differently to ours.[1]

1.1. BEPS and EU action points

In a previous contribution to *European Taxation*, the author highlighted the shortcomings of the existing corporate tax systems that have evolved over time in the Western world.[2] These shortcomings can be found at both the domestic level (the Netherlands was used as an example) and at the international level. The entire list of 15 Actions included in the OECD's Base Erosion and Profit Shifting (BEPS) initiative,[3] together with multiple actions endorsed by the European Commission in its fight against aggressive tax planning (ATP),[4] represent an attempt to overcome these shortcomings by suggesting (and, to the extent possible, imposing) amendments to national tax systems, tax treaties, as well as the issuance of new guidelines on the allocation of the corporate tax base of multinational enterprises (MNEs) across jurisdictions.[5] The question that arises is whether the OECD and European Union are on the right track with their BEPS and ATP Action Plans, or whether these Action Plans are merely attempts to defend the dysfunctional and outdated corporate tax systems of the jurisdictions involved. National corporate tax systems, designed and developed in a domestic environment, have served their time quite well, but as the OECD/BEPS and EU/ATP action plans illustrate, they have come to the end of their natural life cycles, mostly due to the international disparities and mismatches of these domestic systems, which cannot be solved without going back to the drawing table. In other words, would it not be better to consider alternative and sustainable concepts of taxing corporate profits, the starting point of which would be a globalized economy?

1.2. Why should states levy corporate tax?

Returning to the question of why a jurisdiction would typically want to levy a corporate income tax (CT), in short, the following main functions of a CT can be distinguished. First, the complementary function vis-à-vis personal income tax levied on individuals. It would be difficult to imagine a country levying income tax on individuals, including self-employed entrepreneurs, without levying a similar kind of tax on income (profits) earned by entities. From this perspective, CT, as a whole, can also be regarded as an anti-avoidance measure to safeguard the levying of personal income tax on entrepreneurs, although this argument seems to be more valid for family-owned businesses than for listed MNEs. Second, CT provides tax revenue to finance a country's government expenditure. Taking into account the fact that the revenue from CT is relatively small compared to GDP – 3% of GDP in the OECD area (in the Netherlands it is below 2%) – this argument, while on the one hand still valid, and especially so in periods of economic downturn when governments are running budget deficits (particu-

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1. H.J. Hofstra in a report on the influence of the Netherlands tax system on the economic and social structure of Netherlands society: *De invloed van het hier te lande geldende belastingsysteem op de economische en sociale structuur van onze maatschappij en op het beleid, dat door de ondernemers in hun bedrijven wordt gevoerd, Prae-Adviezen, Vereniging voor de Staathuishoudkunde* pp. 25-26 (Martinus Nijhoff 1953).
2. J.W. Bellingwout, *Corporate Income Tax: Marking the Passage of Time*, 54 Eur. Taxn. 5, pp. 171-177 (2014), Journals IBFD.
3. For a general introduction and overview of the OECD BEPS Action Plan *see*: OECD, *Addressing Base Erosion and Profit Shifting* (2013), International Organizations' Documentation IBFD; and OECD, *Action Plan on Base Erosion and Profit Shifting* (2013), International Organizations' Documentation IBFD. These reports, as well as the detailed follow-up draft reports per individual Action item published in 2014 and to be published in 2015 are available at www.oecd.org/tax/beps-reports.htm.
4. Communication from the Commission to the European Parliament and the Council: An Action Plan to strengthen the fight against tax fraud and tax evasion, COM(2012) 722 final (6 Dec. 2012), EU Law IBFD; European Commission, Commission Recommendation regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters, C(2012) 8805 final (6 Dec. 2012); and European Commission, Commission Recommendation on aggressive tax planning, C(2012) 8806 final (6 Dec. 2012), EU Law IBFD.
5. To highlight the draft reports on two Action item (nos. 6 and 8) as an example *see*: OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, OECD/G20 Base Erosion and Profit Shifting Project* (OECD 2014) and OECD, *Guidance on Transfer Pricing Aspects of Intangibles, OECD/G20 Base Erosion and Profit Shifting Project* (OECD 2014).

larly those that suffer from the EU deficit cap of 3% of GDP), on the other hand also provides a window to introduce or increase other taxes that could easily replace the relatively minimal CT revenue from a mere budgetary perspective. Third, as more recently alluded to by the OECD in its BEPS Working Papers,[6] there is a psychological or even sociological argument that needs to be factored in. In this regard, reference is made to the need to have a CT that supports the "fairness" and the "integrity of the corporate tax system" as a whole, framed in the context of the current debate on tax morality and on the corporate social responsibility of MNEs. "Why should I pay tax if big multinationals don't?" seems to be the underlying feeling of the public at large. This frustration, which is not new but tends to surface in times of economic crisis, is fed not only by NGOs that suddenly play an active role in this tax debate and that issue reports with manipulative and aggressive narratives on tax planning by MNEs, but also by the media, which is eager to focus on this perceived dark side of our economy in order to sell newspapers. Finally, countries that do not levy any CT have been addressed in the policy guidelines of the OECD/BEPS paper on Action No. 6 (Treaty Abuse). According to these policy guidelines, there is no need to conclude tax treaties with zero (corporate) tax jurisdictions, as there is no need to avoid double taxation in relation to these countries.[7] Although much can be said against this line of politically-based reasoning, if BEPS Action No. 6 is successful in bringing the phenomenon of "treaty shopping" to an end, capital exporting countries and capital importing countries will want to have strong tax treaty networks in order to have direct access to source countries and to provide direct access to foreign direct investment. For example, in the current situation, it has already become apparent that it is difficult for countries in the Middle East that do not levy a standard corporate tax to bring their domestic companies under the protective umbrella of tax treaties by applying the OECD Model (2010)[8] (or the UN Model (2011)).[9,10]

1.3. Who actually pays for the CT?

Looking at the design and format of the existing CT systems in the Western world, the primary question is: who actually carries the burden of CT? Milton Friedman gave the answer: it is not the corporate taxpayer – the company itself – but its customers, employees and shareholders.[11] While this may have been true in the post-WWII era when the economic parameters were mostly of a domestic nature, nowadays it should be added that if Japanese MNEs selling consumer products were to pass on their high CT burden to consumers by increasing prices, and if Singaporean MNEs were to do the same, although with respect to a much lower Singapore CT burden, the Japanese MNEs would soon be out of business due to the more competitive pricing of their Singaporean counterparts. The transfer of CT burdens to customers is bound by the economic laws of competition in an increasingly globalized playing field. The same is probably true for the shareholders of MNEs, in light of the high mobility of capital. If, due to a relatively high CT burden, the yield on a share investment in a Japanese MNE is below the yield on a share investment in a similar Singaporean MNE, the investor could easily switch from the former investment to the latter. Simply offering shareholders a lower rate of return due to an increased level of CT does not seem to work in a highly globalized investment environment. This means that MNEs hypothetically – the author has not performed any research on this matter and if such research had been conducted the outcomes would have been extremely unreliable due to a lack of expertise in this area – could, for the most part, transfer their CT burden to their own workforce, resulting in downward pressure on wages and wage increases. The average Japanese employee cannot easily resign from a position with a Japanese employer, emigrate to Singapore and sign up with a Singaporean MNE. Again, without being able to rely on a proper authoritative study in this respect, one can imagine that if corporate taxpayers are inclined to transfer their CT burden to another party, shifting part or all of the tax burden to their own employees is probably their best option.[12] If true, this would be an interesting conclusion in light of the fairness and tax morality issue, because those who are advocating that MNEs should pay more corporate tax (either via legislative or behavioural changes), might be the ones who, in the end, have to absorb part or all of this additional corporate tax burden.

1.4. Normal rate of return versus residual profit

Continuing on with the assumption that MNEs are, to a certain extent, able to shift their corporate tax burden to other parties, it has been argued that this would most likely be true for profits that represent a forecasted, normal rate of return on the MNEs' investments, but less likely with respect to windfall or residual profits.[13] From a conceptual point of view it would, therefore, make sense to levy CT on residual profit only and to exempt income that reflects a normal rate of return.[14] In practice, however, it can be concluded that it has been much easier for governments and their tax authorities to tax routine profits of MNEs than to lay their tax levying hands on residual profits. The residual profits of MNEs tend to be earned by group companies located in low-tax jurisdictions, leaving an eroded tax base behind for the high-tax jurisdictions. As emphasized

6. *Addressing Base Erosion and Profit Shifting*, *supra* n. 3, at pp. 8 and 50.
7. *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, *supra* n. 5, at pp. 102-104.
8. *OECD Model Tax Convention on Income and on Capital* (22 July 2010), Models IBFD.
9. *UN Model Tax Convention on Income and on Capital* (1 Jan. 2011), Models IBFD.
10. For instance, many tax treaties concluded by the United Arab Emirates (UAE) require a company to be subject to tax in the UAE in order to be "resident" in the UAE for purposes of the treaty, although effectively the UAE does not levy a tax on corporate profits other than from foreign banks and from the extractive industry (both at the Emirates level). For a thorough analysis of the UAE's tax treaty network, *see* D. Russel, *CIOT UAE Paper 2014*, available at the Chartered Institute of Taxation website: www.tax.org.uk/members/events/Previous+Events/Middle+East+April+2014.
11. A video of Milton Friedman's lecture on the "free lunch myth" is available at www.youtube.com.
12. I.e. after other cost-cutting measures, such as aggressive procurement on suppliers, have been exhausted.
13. Bellingwout, *supra* n. 2, at p. 177.
14. Id., at p. 177.

in the author's previous article, BEPS is mainly about tackling this issue, i.e. trying to find ways for governments to effectively also get a grip on residual profits within the framework of existing CT regimes. This would require a fundamental change to (1) the principles of profit allocation (ownership of IP versus turnover in a domestic market place), (2) the way CT systems deal with the deductibility of payments (triggering the need to distinguish between payments made to different group companies and why, resulting in the need to determine if they are sufficiently taxed in the hands of the recipient, versus accepting a deduction if the expense is at arm's length), (3) access to tax treaties in light of source country claims on taxing profits from permanent establishments (PEs); and (4) levying withholding taxes on outbound payments (BEPS Action No. 6 could have relegated treaty shopping to the history books but probably will not do so due to a lack of unanimous support); to name but a few. So, if an objective and pragmatic view on these opposing directions is taken, it seems that a proper CT tax system, which is based on the three main pillars highlighted above, should, first of all, leverage the fact that routine profits can be taxed fairly easily ("proven concept"), but at the same time should be modest in defining the tax burden on these routine profits. Secondly, a proper CT system should take into account the fundamental difficulty and practical obstacles of getting a grip on residual profits by individual taxing jurisdictions. Assuming that this solution cannot be found in the OECD's BEPS reports and EU ATP action plans, new ways of taxing residual profits need to be found. This would need to be a joint effort by jurisdictions that would otherwise be engaged in tax competition with each other.

1.5. Legal reality as a problem

Finally, two shortcomings in current CT systems should be pointed out, which are, in a way, intertwined:

– the fact that CT systems tend to follow the legal "reality" of a company, and other corporate bodies, being a separate entity for tax purposes, i.e. the concept of the standalone "taxpayer" for corporate income tax purposes; and
– the fact that CT systems tend to follow the legal and economic ownership of assets, liabilities and contractual arrangements, which are legally attached to these separate taxpayers and form the basis of attributing income and expenses to these entities in determining the corporate income tax base of these entities.

Looking at the BEPS Action Plan alone, many of the 15 Actions relate to issues caused by one of these two fundamental elements or a combination of both. As an example, a tax structure aimed at treaty shopping – to benefit from the source country's reduced withholding tax rates under the treaty – can only "work" if the jurisdictions involved accept the fact that a company can claim treaty benefits in respect of income that, in a world without corporate taxation, would never have been earned by this company but by another entity within the corporate group (the "original investor"), who in fact made the investment to which this flow of income relates. Treaty shopping would not be possible if the separate legal existence of the interposed company (sometimes with minimal or no substance) were to be disregarded for CT purposes and/or if the flow of income, which is routed via this company and that consequently benefits from the tax treaty network of the country of residence of this company, were not attributed to this company but directly to the original investor. Controlled foreign company (CFC) legislation generally follows this approach from the perspective of an investor's country of origin, but source countries typically do not apply the same CFC concept in reverse. As this example illustrates, transfer pricing is not only about the arm's length pricing of intercompany transactions, which is recognized as such between two group companies that are also recognized for CT purposes; it also needs to develop guidance on the question of to which entity and to which activities within a corporate group a specific transaction should be attributed and how the nature of this transaction should be classified or determined on the basis of underlying functionalities.

1.6. Transfer pricing

In a way, a dead-end has been reached with regard to these two fundamental shortcomings. Tax systems were built on the legal reality of civil and corporate law, which encompass the freedom of choice that is embedded in our society, resulting in a reality that can be created (not to mention "manipulated"). Applying economic substance criteria to properly assess the relevance of this legal reality for CT purposes may – perhaps – cure the symptom[15] but will probably not solve the shortcomings embedded in the dependency of corporate tax systems on legal starting points, such as the legal existence of a company or the legal "truth" of a contract. Transfer pricing, originally intended as a cure for the benefit of the country of origin of MNEs, who struggle with "their" MNEs earning profits offshore. Transfer pricing, which was applied as a framework to allocate income back to these countries of origin (the United States in particular), turned out to have the side effect that interest, royalties, service fees and other arm's length expenses were being used to reduce the tax base in high-tax source countries without the corresponding income streams ending up in the country of origin of the MNE; instead they accumulated in low-tax jurisdictions, allowing the income to be held offshore. Additionally, the current transfer pricing framework – if it works the way it was intended to – seems to be geared more towards well-developed, capital exporting countries of origin that employ a high-end labour force, than to less developed, capital importing source countries that employ a low-end labour force and that allow foreign businesses access to their markets.

1.7. International mismatches

In addition to these fundamental shortcomings there is (1) the lack of international harmonization and coordination, resulting in double taxation and double non-taxation, mismatches in entity classification (transparent versus non-transparent), mismatches in financial instrument classi-

15. Assuming that these economic criteria cannot be manipulated either.

fication (debt/equity), mismatches in PE thresholds and allocations of assets and income, mismatches in the timing of profit and loss realization and even mismatches in the applicable transfer pricing arm's length criteria; and (2) the fact that some jurisdictions actively benefit from this lack of coordination and harmonization, and even engage in tax competition in order to attract a tax base from foreign MNEs. Therefore, it may very well be concluded that a more far-reaching solution is required to fix these problems than the G20-OECD/BEPS and EU/ATP projects can ever accomplish with the current design of their action plans.

1.8. Wish list

In an ideal world, a far-reaching solution would, of course, need to solve all, or at least most of, the issues that are within the scope of the OECD/BEPS and EU/ATP Action Plans; it should not result in a step back for cross-border services and trade (which BEPS/ATP currently tend to represent), but in an outcome that is beneficial to global/European MNEs. A new design for a CT system will require a high degree of harmonization. Focusing on the European Union as the starting point for such a harmonized CT system, the system should, due to its level of harmonization, relegate harmful tax competition between Member States and illegal State aid to history. It should also reduce the importance of transfer pricing and the arm's length principle; consequently it should reduce the administrative burden of the CT system for both taxpayers and the taxing jurisdictions. It should remove existing obstacles to the exercise of the fundamental freedoms of the Treaty on the Functioning of the European Union (TFEU) (2007),[16] including exit taxes and the disparities that currently cannot be resolved by the Court of Justice of the European Union (ECJ) on the basis of these freedoms, such as mismatches and double taxation. Furthermore, such a harmonized system should apply equally to EU and non-EU based MNEs. It should make withholding taxes on dividends, interest and royalty flows redundant within the European Union, including withholding taxes on payments made from the European Union to recipients in third countries. Similarly, CFC legislation within the European Union and of Member States in relation to third countries should no longer be necessary. Finally, such a new regime should improve the establishment climate within the European Union as a whole, should be less distortive than the current CT regimes from an economic point of view and should even serve as an example for other regions/jurisdictions due to its simplicity, efficiency and attractiveness for all of the parties involved.

2. Blueprint for a New CT System

2.1. Introductory remarks

Before exploring what a new CT system would look like (sections 2.4.-2.8.), the potential building blocks that could function as the cornerstones of such a system (sections 2.2. and 2.3.) need to be examined.

2.2. Routine functions versus windfall/residual profit

The blueprint for a new CT system would involve a distinction between (1) a normal rate of return on the investment made by the enterprise and its shareholders, which is in fact a return on routine functions; and (2) an additional return on top of this (windfall profit or residual profit), which, by definition, cannot easily be linked to functions carried out within an MNE, let alone be easily allocated to separate jurisdictions (for example, income from creating, owning, defending, managing and exploiting IP). Countries have been more successful in levying CT on tax bases that represent a normal or standard rate of return than on residual profits. This is due to the fact that most base eroding tax planning schemes focus on shifting residual profit from high-tax to low-tax jurisdictions (for example, through the tax deductibility of interest, royalty and service payments, or via contract manufacturing, contract R&D, and commissionaire or limited risk distributor arrangements), usually leaving behind a normal rate of return as the taxable profit in the high-tax jurisdiction. Countries have been struggling to combat these base erosion schemes by imposing restrictions on the tax deductibility of interest, royalty and other payments, by imposing stricter transfer pricing requirements to reduce the volume of these payments and by claiming the existence of additional functions in these countries that justify a higher profit allocation or even the existence of a PE in these countries. The need for the coordinated OECD/BEPS and EU action plans demonstrate how difficult it is for separate jurisdictions to successfully proceed along this route. At the same time, there may be serious doubts as to whether or not the OECD and European Union can solve these problems. So why not step back and accept, as a first step, that jurisdictions are very well equipped to tax routine functions based on a standard rate of return, and to only focus on this part of the overall profit of an MNE when designing a new harmonized CT base within the European Union? This does not mean that residual profits should not be taxed, but if it is concluded that it is difficult for individual jurisdictions to allocate and tax residual profits, the successful taxation of residual profits may require, as a second step, a higher level of integration within the European Union than the taxation of a return on routine functions. A higher level of integration could mean that the taxation of residual profits is no longer a matter for individual jurisdictions, but a levy organized at the EU level, based on new parameters that determine the volume of these residual profits and the allocation of these residual profits to the European Union as a region. Consequently, this idea involves a two-pronged approach pursuant to which (1) individual Member States retain their sovereignty to tax corporate profits, i.e. on a harmonized tax base that reflects a normal rate of return on routine functions and (2) residual profits become subject to an EU-centralized tax levy.

16. Treaty on the Functioning of the European Union of 13 December 2007, OJ C115 (2008), EU Law IBFD.

2.3. New common corporate tax base

It would be naive to expect this to be easy. But the first step, to design and introduce a new common corporate tax base (NCCTB) that only consists of an arm's length return on routine functions, should be much easier to accomplish than the approach taken so far with the CCCTB, which is still based on the desire to include residual profits. Low risk or routine functions are typically remunerated on the basis of an arm's length profit, which is either based on the cost-plus (CP) method (or the various other methods related to the cost-plus method), or on a relatively small spread or margin on the taxpayer's individual turnover. Quite often, the volume of turnover does not necessarily relate to the functions performed and to the risks incurred, which creates the impression that taxing a volume-based remuneration may partially overlap with the taxation of residual profits. The suggestion, therefore, would be to only apply a cost-plus approach when defining the tax base of this NCCTB. An across-the-board CP approach would also avoid double taxation of routine functions within the European Union, which could occur if some Member States were to apply a CP approach, while others apply a volume-based approach. Also, applying a volume-based approach would mean a step back towards the existing – and, in fact, unsolved – problem of determining a company's individual turnover, which is much easier to manipulate and is much more of a legal reality than a company's cost base. The latter is, in effect, a measure of the substance of a company in terms of real or economic presence in a jurisdiction.

Using the CP method as the common denominator for the new harmonized tax base has many advantages. First, it would satisfy the voices raised in the public tax debate that have pleaded for a CT regime based on economic substance. It should (1) be far less complex as a system for all parties involved; (2) provide advanced certainty; (3) avoid double taxation on its own; and, as such, (4) result in acceptable effective tax rates (establishment climate). It would be difficult to avoid, and it could leave the amount of the markup (the CP percentage) and the CT rate to be applied on this markup to the discretion of individual Member States.[17]

2.4. Defining the tax base

In trying to define the costs that are relevant for a harmonized CP tax base, although the existing guidance with respect to applying the CP or TNMM method[18] could be a useful starting point, it cannot be decisive, as the NCCTB clearly will have a wider scope than the activities that are currently within the reach of the CP and TNMM approaches.

2.4.1. Interest expenses

As a starting point, and also to a large extent in line with the current CP and TNMM methods, interest expenses (including third-party interest expenses) should be excluded from the CP cost base of the NCCTB. Consequently, if this NCCTB approach is adopted, CT regimes would finally get rid of the practical problem of base erosion and profit shifting via interest expenses (very often paid to low-taxed group finance companies) and of the more fundamental problem of why equity funding should be treated differently from debt funding. Needless to say, a carve-out of interest expenses would also make tax planning with respect to hybrid instruments redundant (OECD/BEPS Action No. 2). Due to its focus on group interest expenses, OECD/BEPS Action No. 4 would also no longer be needed, as this NCCTB proposal for a complete carve-out of interest expenses, including third-party interest expenses, should completely solve the interest expense issue. Thinking along these lines, it would also make sense to exclude other elements related to loans receivable/payable from the tax base, including currency exchange gains and losses and write offs of intercompany receivables due to an intercompany bad debt risk.

2.4.2. Intercompany payments

An important issue to examine as a next step is whether expenses paid to group companies (either paid and received within the same jurisdiction or on a cross-border basis) should be part of the cost base. At first glance, it would make sense to exclude intercompany expenses to avoid double taxation. If Company A were to lease an aircraft to its affiliate Company B, it would be undesirable to have both companies report a margin on their costs with respect to the same aircraft (depreciation for Company A and lease payments for Company B), which would not happen if Company B owned and operated the aircraft at the same time. A carve-out of intercompany expenses would bring the NCCTB system closer to the concept of a consolidated tax base as applied under the CCCTB proposals, although without the need for a formula. In the example herein, only Company A would report a margin on the expenses related to owning the aircraft (depreciation of the asset, third-party expenses related to maintenance, if borne by the owner, expenses related to the registration of the aircraft, etc.). Company B would report a margin related to the use and operation of the aircraft (staff salaries, fuel, airport fees, maintenance to the extent borne by the lessee, etc.). Furthermore, if intercompany operating expenses were to be included in the CP cost base, it would still require arm's length intercompany pricing in order to determine a proper tax base. By carving out these intercompany expenses, transfer pricing would largely no longer be relevant, as it would mainly serve as an instrument for cost allocation of third-party expenses between jurisdictions.

17. As the NCCTB would also result in a markup on the cost of labour, from this perspective, corporate tax would no longer be subject to corporate income tax competition between Member States, as the corporate tax on the CP markup on labour costs would be integrated into labour costs in terms of salary, wage/income tax and social security contributions.
18. OECD, Centre for Tax Policy and Administration, *Review of Comparability and of Profit Methods: Revision of Chapters I-III of the Transfer Pricing Guidelines* (OECD 2010), with particular reference to paragraphs 2.39-2.55 with respect to the cost-plus method, and paragraphs 2.92-2.98 with respect to the transactional net margin method.

2.4.3. Substance

If the tax base of the NCCTB were to focus only on external expenses, leaving intercompany expenses aside, the expenses to be taken into account would, for example, be those related to employees, such as wages (and associated social security and pension contributions); expenses related to the investment in and deployment of assets, such as depreciation and amortization of tangible and intangible assets; lease payments (if paid to a third party); and expenses paid to internal and external service providers. In short: direct and indirect expenses, operating expenses, as well as general, legal and administrative expenses, irrespective of whether these expenses, for instance borne by Company A in Member State A, should economically be allocated in whole or in part to its affiliate Company B in Member State B. If defined along these lines, the tax base would better reflect economic substance in terms of physical presence and activity in the Member State involved. MNEs would be free to decide where to maintain such a level of substance. Obviously, under this approach, the current attribution of profits to IP companies located in low-tax jurisdictions would no longer be possible, assuming that it will be difficult to establish a tax base from an NCCTB perspective in low-tax jurisdictions because this would imply having significant substance (including employees) in those jurisdictions. At the same time, a CT levied on the basis of economic substance would or should also satisfy those segments of the public and those at the government level who are demanding that MNEs pay their "fair share", as the term "fair share" would ultimately have a common understanding based on the economic cost base and physical presence.

2.5. Defining the taxpayer

2.5.1. Aggregate tax base per country

If intercompany transactions were irrelevant in determining the tax base, this would not only mean that transfer pricing with respect to such intercompany transactions – in terms of pricing and allocation of income and expenses – would be meaningless, it would also open up the possibility of a huge efficiency "gain", as the number of companies a group has in a jurisdiction would no longer be relevant. The carve-out of intercompany expenses would facilitate the aggregation of all the cost bases of all group companies resident in a given Member State, including branches of non-resident group companies, reducing all the affiliates of the same MNE resident in one Member State or operating in that Member State via a branch to a single corporate taxpayer on behalf of the MNE vis-à-vis that Member State. This aggregated approach could be applied without need for the present consolidation technique, which currently usually requires a much more complicated regime, with corresponding anti-avoidance measures. If Company A and Company B in the previous example are resident in the same country, the cost bases of these companies can be aggregated and one of the two companies could file the aggregate CT return based on the CP method on behalf of both of them (obviously the other company would have an obligation to internally contribute its share of the CT due and most likely there would be shared external – several – liability towards the government for the payment of the total CT due).

2.5.2. Letterbox companies, conduit companies, SPVs

Reducing a group of companies within one country to a single tax reporting entity also has the advantage of more or less ignoring the existence of companies that have a low level of physical presence (no employees for instance) and in respect of which the business operations primarily take place through contractual arrangements that trigger income and expenses. The fact that these companies as individual taxpayers (and, in a broader sense, the paper world of the "legal reality" of corporations and contracts), have been able to play such an important role in the present corporate income tax environment, has raised criticism in the public tax debate and indeed can be seen as a weakness of the present CT regimes. Without entering into a discussion of whether this criticism is right or wrong from the present regime's perspective, from the point of view of the NCCTB the use of SPVs by MNEs would no longer be an issue, as these SPVs would simply be absorbed by the other activities of the MNE in the same country (and thus also benefit from the "substance" of these other activities). If a non-EU MNE were to have no other activities in a Member State apart from operations through a single SPV, it would be clear that the SPV – assuming a very low level of physical substance and a similarly low level of external operating expenses – would barely report any income, which would be clear to everyone concerned and would allow other countries (that do not follow the NCCTB concept) to draw their own conclusions.

2.5.3. No need for cross-border consolidation

In line with the fact that a consolidation of profits is not required at the domestic level, there is also no need for an EU-wide consolidation of profits earned by the group companies of an MNE that are resident in different Member States. Each Member State can tax its own tax base without taking into account the tax bases that other Member States define – on the basis of the NCCTB – with respect to their domestic companies that belong to the same MNE. Hence, no formula would be required to allocate the MNE's profits to the different Member States in which the MNE carries on its business as a group. The cost base of the NCCTB, free from intercompany expenses, is a formula in itself. The fact that each Member State will have a positive CT base due to the NCCTB means that intra-EU cross-border losses and distortions between purely domestic activities, on the one hand, and EU cross-border activities on the other, would be no cause for concern.

2.5.4. Collective investment funds

Today's CT regimes often grant corporate tax exemptions or zero tax rates to collective investment funds, usually based on the rationale that it is better not to add a layer of additional tax and it is economically more efficient for entities to centralize and outsource the investment and management of portfolio assets to a separate entity (economies of scale, expertise, etc.). It is not always easy to draw a line between exempt and taxable investment funds, as the parameters for exclusion from the tax net may consist of a combination of the nature of the fund's activities, the type of assets invested in, the legal form of the entity, the requirements with respect to the profile of shareholders, restrictions on the entry and exit of shareholders to/from the fund, the fund's annual dividend policy, and so on. Assuming that the cost base of most investment funds in terms of salaries and outsourced services is relatively small compared to the volume of assets, it may be worthwhile to dispense with the old exemption approach and include investment funds as taxable entities in the NCCTB. Obviously, in order to make this work, financial expenses related to, for instance, interest rate swaps and currency hedges should not be part of the CP tax base. If it seems feasible to include CIVs in the tax net of the NCCTB, a similar approach could also be explored for pension funds and sovereign wealth funds.

2.5.5. *Government-owned enterprises*

Another difficult issue faced by corporate income tax regimes across the European Union is the taxation or non-taxation of government-owned enterprises. Very often these enterprises are carried on by governmental bodies and by companies controlled or owned by governmental bodies. The European Commission actively urges Member States to properly tax these activities to avoid illegal State aid, but it is not always an easy task to include these activities in the corporate tax net given the not-for-profit governmental environment of these activities. It is particularly difficult in situations in which these activities are not ring-fenced from the not-for-profit activities. Also, the diversity of public and private legal forms of these governmental business activities can make it difficult, under the existing regimes, to define who the taxpayer should be for these activities. The introduction of a CP-based harmonized corporate income tax could perhaps facilitate the inclusion of government-owned enterprises, as it will make it easier to overcome these obstacles.

2.5.6. *Hybrid entities*

The introduction of an NCCTB would probably also reduce the negative impact of hybrid mismatches between Member States in their classification rules with respect to taxable entities. This is so, firstly, because many of these hybrid entities play a role in flows of intercompany payments resulting in double deduction or deduction and non-inclusion (to follow the BEPS terminology). As these intercompany payments are already carved out of the NCCTB tax base, as highlighted in section 2.4.2., no further benefits from hybrid mismatch planning are to be expected in these situations. To the extent that hybrid entities are used to obtain a double deduction for payments made to third parties, the most important category of expenses, namely interest expenses, is already carved out of the NCCTB's tax base, which will significantly reduce the possibilities of aggressive tax planning in this area. Whether partnerships and other hybrid entities should be defined as taxpayers under the NCCTB can continue to be a sovereign matter for the Member States, as this has more to do with the fine domestic line between enterprises carried out by individuals subject to personal income tax and enterprises carried out by entities as separate taxpayers subject to CT. Within the framework of the NCCTB, the role of hybrid entities within MNEs should be limited due to the fact that the tax base will be defined along the lines of aggregated substance and not along the lines of separate entities and residence.

2.6. Dividends, capital gains, CFC, withholding tax

2.6.1. *Dividends*

Assuming that the NCCTB is implemented by all Member States, intercompany dividends would not play a role in the tax base of the parent company or intermediate holding company. This would be true irrespective of the nature and volume of the shareholding (i.e. not only dividends from group companies but, in fact, all dividends received, including portfolio dividends). Accordingly, this tax carve-out of dividend income would have a much broader scope than the current scope of the EU Parent-Subsidiary Directive (2011/96) with respect to dividends received. Equally, there seems to be little room for Member States to levy a withholding tax on dividends paid. If income is an irrelevant concept for the NCCTB, the distribution of income should be irrelevant as well. If this were not the case, the situation would fall back within the realm of profit attribution and transfer pricing disputes. In fact, there is no room for economic double taxation under the NCCTB – once on the initial profits at the level of the operating company and once on the distributed after-tax profits at the level of the shareholder – because each company in the ownership chain would be taxed on its own cost base. Consequently, the concept of economic double taxation of profits would simply not exist.

2.6.2. *Capital gains*

As is the situation with dividends, capital gains on shareholdings are not part of the tax base of the NCCTB. Equally, capital losses on share investments in subsidiaries and portfolio shareholdings are not deductible. This approach is not, however, limited to gains and losses on shareholdings. As indicated in section 2.4.1., in line with the carve-out of interest income and interest expenses, capital gains and losses with respect to intercompany and third-party loan receivables/payables are also not included in the tax base. A next step in this direction would be to conclude that no capital gains/losses whatsoever, i.e. regardless of the asset/liability, can form part of the CP tax base of the NCCTB. This would, however, create problems due to the fact that amortization and depreciation expenses of operating assets, such as machines, would be part of the expenses on which a margin should be reported under the CP approach. If a machine, with a cost price of 100, which has been depreciated over time to a residual value of 10, is sold for a price of 30, an amount of 90 (to determine the applicable margin) has, in fact, been included in the CP tax basis of the NCCTB, whereas only 70 should have been included. From this perspective, a capital gain of 20 should result in a reduction to the cost base of 20 upon realization, resulting in a corresponding reduction in the margin to be reported. Likewise, if the same machine is sold for 1, the capital loss of 9 should be treated as an additional expense on which the CP margin is to be reported. It would require too much detail at this stage to elaborate on this further, but it is conceivable that there should be a line between (1) capital gains/losses with respect to assets that are subject to annual depreciation and amortization (such as operating tangible and intangible assets) and (2) capital gains/losses with respect to assets and liabilities that are normally not depreciated or amortized (such as financial assets/liabilities).

2.6.3. CFC

As the NCCTB would effectively operate as a territorial tax system, there is no need to include income from foreign base companies in the tax base of the domestic direct or indirect parent company. This would be true for controlled foreign companies within, as well as outside, the European Union. As the NCCTB would follow economic substance, it would not be possible to shift income from a high-tax EU jurisdiction to a low-tax third-country jurisdiction (with respect to an IP license or group financing activities, for example). From an NCCTB perspective, only a shift of economic substance to a third-country would mean that the tax base would be shifted to that jurisdiction, but such a shift would typically not trigger anti-avoidance measures because it would be embedded in economic reality. Of course it would mean that the European Union, even with an NCCTB-type of tax regime, needs to maintain a competitive tax climate for domestic and foreign direct investment, but this would be no different from the need to maintain a well-educated, highly skilled and affordable workforce in combination with a balanced labour law environment.

2.6.4. Withholding taxes

As mentioned in section 2.6.1., the NCCTB does not leave room for the levying of withholding tax on the payment of dividends. This is true for intra-EU dividends, as well as for dividends paid from a Member State to a third country. In fact, the same approach can be applied to withholding taxes on interest and royalty payments. Interest expenses as such, and royalties paid to group companies, will no longer be deductible from the tax base, so there is no need for a withholding tax to partially or fully compensate for a deduction. As there is no base erosion, there is also no need for anti-avoidance measures with respect to such interest and royalty flows paid to low-tax jurisdictions. Royalties paid to third parties are included in the tax base of the NCCTB, resulting in a margin to be reported under the CP approach, which means that these royalty flows are effectively already taxed. It can be concluded that there is absolutely no room under the NCCTB to levy a withholding tax on dividends, interest and royalty payments to companies or individuals, whether resident in Member States or in third countries.

2.7. Tax treaties

2.7.1. PE and business profits

Obviously, as with the prevailing CT system, the NCCTB will need to allocate taxing powers among the Member States and between Member States and third countries with respect to corporate tax matters. Although the NCCTB, due to its strictly territorial nature, will significantly reduce the potential for double taxation, there will still be a need to decide whether a cost base incurred by a resident or non-resident company belongs to one Member State or another or to a third country. For that reason, the PE concept may still be necessary, as well as agreement (in the context of article 7 of the OECD Model (2010) – business profits) on the costs allocated to such PEs to avoid the same costs being included in the CP tax base of two Member States (double taxation) and to avoid expenses not being included in the CP tax base of one of the Member States at all (double non-taxation). This does not, however, necessarily mean that these concepts should not be modified to fit the NCCTB framework. In this respect, there should be little difference between intra-EU tax treaties and tax treaties with third countries.[19]

2.7.2. Dividends, interest and royalties

In the absence of withholding taxes levied by Member States that adopt the NCCTB, tax treaties between such Member States will no longer have to provide for a reduction of withholding tax (articles 10, 11 and 12 of the OECD Model (2010)). In relation to third countries, however, a Member State will still want a third country source state to reduce the withholding taxes it levies on its resident companies and individuals. From the perspective of articles 10, 11 and 12, it should be "business as usual" with respect to inbound dividend, interest and royalty flows. A Member State adopting the NCCTB cannot, however, grant a credit for such reduced foreign withholding taxes because the income from dividends, interest and royalties will not be subject to CT, as they will no longer form part of the tax base under an NCCTB regime. Would non-EU source countries mind if dividends, interest or royalty payments were not included in the tax base of the corporate recipient in the Member State? The answer should be "no", given the widespread existence of participation exemption regimes, which exempt dividend income from the tax base at the level of the recipient without affecting the obligation of the source country to reduce its withholding tax under the dividend article of the applicable tax treaty. Another example that is close to the NCCTB in this respect, and that does seem to stand in the way of claiming treaty benefits, is the Netherlands personal income tax regime for passive investments ("box 3"), which only taxes a fixed yield of 4% on investments without including actual (passive investment) income, such as dividend and interest income, in its tax base.

19. Obviously, other elements of tax treaties following the OECD Model may also require further attention in light of the introduction of an NCCTB, for example, article 6 (immovable property), article 8 (shipping and aviation), article 9 (corresponding adjustments) and article 14 (capital gains).

2.7.3. Treaty abuse

"Treaty shopping", with the aim of reducing the withholding taxes of a Member State, would no longer occur due to the lack of withholding taxes within the European Union – at least for those Member States that adopt the NCCTB. Therefore, with regard to intra-EU investments and inbound investments into the European Union, OECD/BEPS Action No. 6 would become a non-issue upon the introduction of an NCCTB. Non-EU source countries could still be confronted with treaty shopping via a treaty with a Member State that has adopted the NCCTB. The current approach of BEPS Action No. 6, however, may not be effective if the recipient country does not tax the income as such, and no longer applies or exploits the concepts of "conduit payments" and "base erosion". This would, therefore, require further analysis. The fact that the Member State receiving the dividends applies a CT regime that is based on the actual economic substance in that Member State, may provide guidance on how the interests of source countries could best be served. Also, the manner in which the European Union will deal with the taxation of residual profits in the European Union may be relevant from a source state perspective. As indicated in section 2.2., the introduction of an NCCTB should be considered together with a centralized EU tax on the residual profits of MNEs that are active in the European Union. Assuming that this EU residual profits tax will include income, or large amounts of income that, in the current situation of non-harmonized domestic CT regimes, is earned by group companies resident in low-tax regimes, which are usually outside the European Union, such an additional EU residual profits tax should play an important role in the decision of source countries to apply reduced withholding tax rates and when drafting the appropriate bilateral or multilateral treaty access provisions.[20]

2.8. Residual profits tax

Technically speaking, it would be an option to simply have a CT on routine profits in the form of an NCCTB within the European Union. Given, however, the focus of the OECD/BEPS (G20, G8) and EU/ATP Action Plans, and given the public tax debate that has arisen as a result of the financial crisis, the psychological element described in section 1., i.e. the integrity of the tax system as a whole, would probably not be satisfied if residual profits earned in the European Union were left untaxed by the Member States. Furthermore, with an eye to the complementary function of CT as compared to individual income tax, which typically includes residual profits of self-employed individuals in its tax net, it would seem logical – in an EU context[21] – to think about a mechanism to tax corporate residual profits on top of the NCCTB, which is designed to only tax routine profits. As indicated in section 1., given the obstacles encountered by individual jurisdictions in taxing residual profits, the best way forward would be to design a residual profits tax that is centrally levied at the EU-level and redistribute the proceeds to the participating Member States. This redistribution does not necessarily have to relate to the taxable activities of MNEs in the individual Member States, but could also follow more political or fiscal (in terms of budgetary) policy lines, to be agreed upon in advance, and perhaps also with a certain extent of autonomy being exercised by the European Union (probably the European Commission). The blueprint for such a residual profits tax will be the topic of a future article.

20. It would make sense to think along the lines of a multilateral tax treaty with the third-country as the contracting party, on the one hand, and the combined Member States participating in the NCCTB as the contracting party (parties), on the other. According to the OECD report on BEPS Action No. 15, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, OECD/G20 Base Erosion and Profit Shifting Project* p. 16 (OECD 2014), International Organizations' Documentation IBFD, expanding the scope of the multilateral instrument beyond the scope of BEPS-related tax treaty issues would be a "significant step towards multilateralism in tax matters".
21. For countries that currently do not levy a corporate tax and an individual income tax, for example, some countries in the Middle East, the NCCTB would suffice with regard to routine profits, should they wish to consider the introduction of a tax on corporate profits. For these countries, the NCCTB would provide a relatively simple format compared to existing comprehensive CT regimes in other countries and would also facilitate transformation from a zero-tax jurisdiction to a taxing jurisdiction for the taxpaying community.